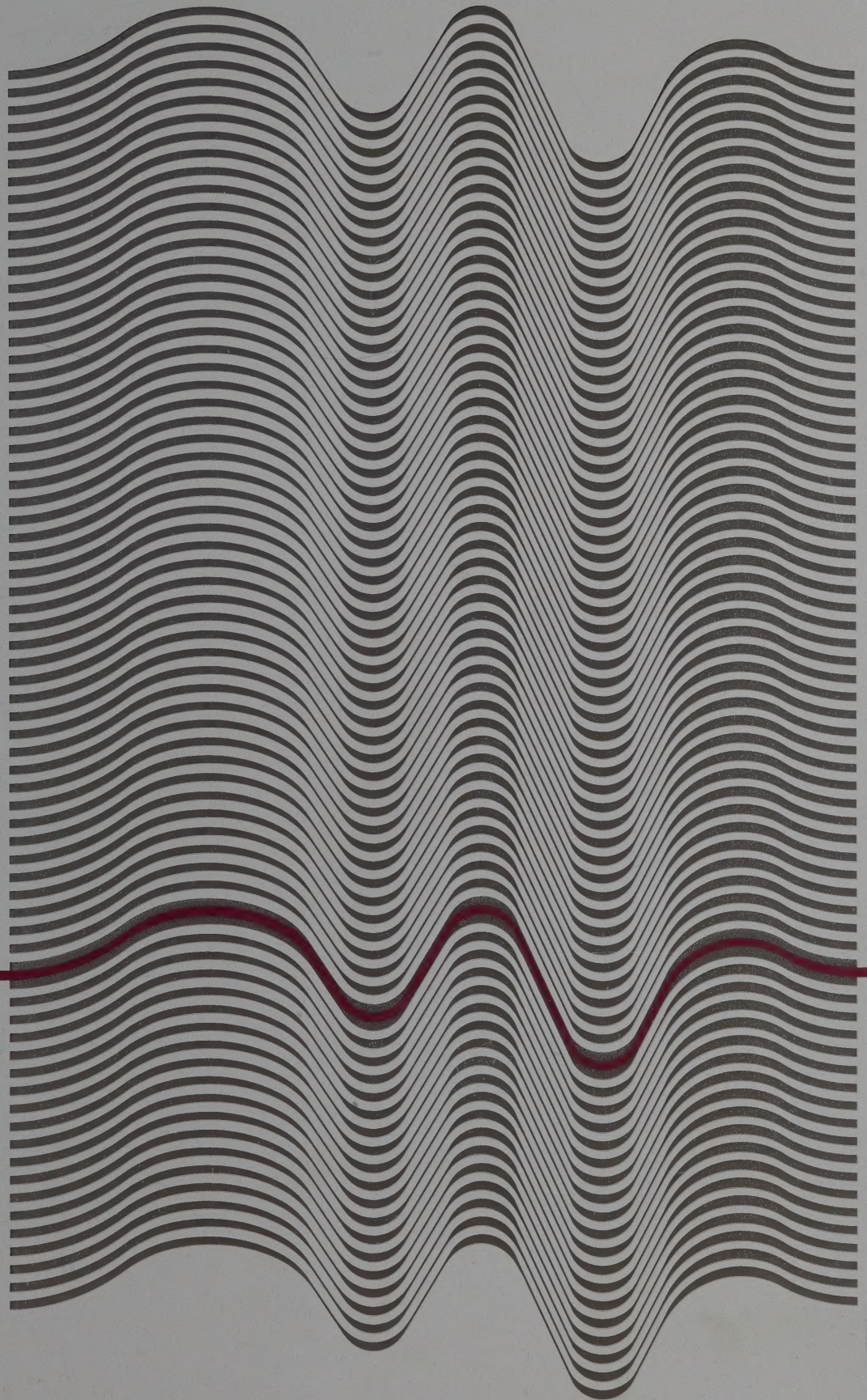


performing
to meet the
challenge
of change



Phillips was founded in Bartlesville, Okla., in 1917 and remains headquartered in this northeastern Oklahoma city.

Phillips is engaged in petroleum exploration and production on a worldwide basis, and petroleum refining and marketing in the United States. The company produces and distributes chemicals in the United States and overseas. The company's operating activities are organized in three groups: Exploration and Production, Gas and Gas Liquids and Petroleum Products and Chemicals. Each group's operations are summarized in individual sections of this report.

At the end of 1985, Phillips employed 25,300 people, had 83,300 shareholders and assets of \$14.0 billion. The company's products and processes were licensed in 37 countries.

About the Cover

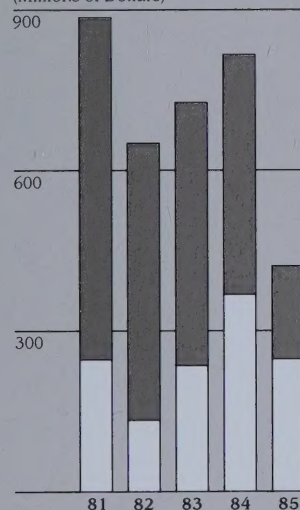
"Performing to meet the challenge of change." This slogan — by senior design engineer A. D. Lanman — was the winning entry in an employee contest to create a phrase that captures the spirit of teamwork and purpose within Phillips. It seems especially appropriate against a backdrop of computer art, which symbolizes the company's maintaining its course through a shifting economic environment.

Contents

Letter to the Owners	2
Exploration and Production	6
Gas and Gas Liquids	12
Petroleum Products and Chemicals	14
People	21
Research and Development	22
Corporate Citizenship	24
Financial Review	25
Financial Statements	31
Five-Year Review	52
Directors and Officers	54
Management and Director Changes	55

Highlights

Net Income (Millions of Dollars)



■ United States
□ Outside U.S.

Millions of Dollars Except
as Indicated

	1985	1984*	1983*
Financial			
Total revenues	\$15,800	15,746	15,409
Income from continuing operations	\$ 596	837	760
Loss from discontinued operations	\$ (178)	(27)	(39)
Net income	\$ 418	810	721
Net income from each dollar of revenue	2.6¢	5.1	4.7
Income per share of common stock**			
Continuing operations	\$ 2.07	1.81	1.65
Net income	\$ 1.44	1.75	1.57
Total taxes charged to income (including discontinued operations)	\$ 1,625	1,661	2,003
Capital expenditures	\$ 1,060	1,368	1,128
Total assets at year-end	\$14,045	16,955	13,088
Dividends paid			
On common stock	\$ 542	362	337
On preferred stock	\$ 12	—	—
Cash dividends per share			
Common stock**	\$.95	.78	.73
Preferred stock	\$ 1.04	—	—
Average common shares outstanding (in thousands)**	278,916	462,247	459,572

*Restated for discontinued operations.

**Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

Thousands of Barrels Daily

Operating			
Crude oil produced			
United States	154	136	127
Outside United States	127	132	120
Natural gas liquids produced	204	192	175
Total liquids produced	485	460	422
Crude oil refined	292	288	260
Petroleum products sold	575	507	505

Millions of Cubic Feet Daily

Natural gas produced	1,306	1,288	1,266
----------------------	-------	-------	-------

"Phillips," "the company," "we" and "our" are used interchangeably in this report to refer to the business of Phillips Petroleum Company and its consolidated subsidiaries. Where reference is made to a particular company, it is wholly owned unless otherwise stated. The company's consolidation policy is to include in financial statements the accounts of companies in which more than 50-percent interest is held, except for an insurance company and a credit company.

Marlex, Ryton, K-Resin and Driscopipe are trademarks for the company's products and processes named in this report.

Our company's accomplishments during a year of significant change were encouraging in many respects. We achieved important financial objectives and continued to strengthen our operating performance. However, our earnings for the year declined, and we are working hard to improve the management of every part of our business. This effort — important under all circumstances — is absolutely crucial in today's environment of sharply lower crude oil prices.

During 1985 we carried out a major financial restructuring of the company. We returned approximately \$4.5 billion in equity to our shareholders by offering a package of debt securities in exchange for 72.58 million of their common shares. Following this exchange, we split our common stock three-for-one, raised our annual common stock dividend to \$1 a share and issued \$281 million worth of preferred stock as a dividend to our shareholders.

The higher level of debt we incurred through the exchange offer has been significantly reduced. This reduction, one of our most important financial objectives, was accomplished through a vigorous program of asset sales, cost reductions, including major early retirement programs, and selective adjustments in our capital spending plans.

During 1985 we reduced our total debt from a peak of \$8.6 billion immediately after the exchange offer to \$6.8 billion at year-end. One key element in our debt-reduction effort was the success of our asset sales program. We realized more than \$1 billion for assets sold during 1985. We received good value for these assets, and their sale will not significantly affect our ongoing businesses.

Our earnings for the year were \$418 million, or \$1.44 a share, compared with 1984 earnings of \$810 million, or \$1.75 a share. These earnings represented a return of 2.6 cents for each dollar of revenue, compared with 5.1 cents in 1984.

The primary factor affecting our earnings in 1985 was the higher interest expense that we incurred as a result of our exchange program. Interest expense before income taxes was \$846 million in 1985, compared with \$314 million in 1984.

Much of this interest — charged as an expense to the company — goes as income to



C.J. Silas



Glenn A. Cox

those who hold our debt securities, including many shareholders who participated in our exchange offer.

Nevertheless, further reduction of our debt in order to bring down interest costs and improve our financial flexibility remains a key objective. Completion of our \$2 billion asset sales program will generate additional cash and give us the financial flexibility to further reduce our debt. Because we have emphasized the payment of short- and medium-term obligations, we do not have large principal payments due on our remaining debt until the 1990s. And because of the debt we have already eliminated, we expect our interest expense will be slightly lower in 1986.

Our earnings in 1985 were also reduced by foreign currency losses and write-downs that we took on some of our assets, including those associated with our discontinued minerals operations. Another factor was lower prices for our crude oil, natural gas liquids and petroleum products. Although lower prices were a relatively minor factor in our 1985 earnings, they may have a much bigger impact in 1986.

1985 Accomplishments

A detailed review of Phillips major operations during 1985 begins on page 6. However, some of our key accomplishments are worth summarizing here, since they have clear implications for our performance in the future.

- We made important new discoveries of oil and natural gas. Our most promising domestic discoveries were offshore California, where we found oil in the northern portion of the Santa Maria Basin, and gas in the Gulf of Mexico. Our foreign exploration efforts were rewarded by two discoveries off the coast of the People's Republic of China and by discoveries in Indonesia and in the U.K. North Sea.
- We made significant progress toward development of the Point Arguello field offshore California. One production platform was installed during the year, and a second is scheduled to be in place by mid-year. We should be producing from Point Arguello by mid-1987, and we continue to be one of the most active companies involved in this promising area.
- We began a program of gas reinjection at our Ekofisk field in the Norwegian North Sea. By stabilizing reservoir pressure, we expect to reduce subsidence of the sea floor that has caused some of our production facilities to rest lower in the water. While safety margins have not been exceeded, we are looking at other possible methods of reducing subsidence, including nitrogen injection, which could have the added benefit of increasing our total hydrocarbon recovery from the reservoir. Greater oil recovery is the objective of the water injection program we have initiated at Ekofisk. Our first injection platform will be completed this year, and water injection will begin in 1987.
- We remained the nation's largest producer of natural gas liquids and greatly expanded our gas gathering system. Through a vigorous effort to secure new supplies, we increased our U.S. NGL production by 7 percent and added many new connections to our pipeline network — particularly our Seagas system, which extends from Oklahoma to the Texas Gulf Coast.
- We consolidated our downstream operations. Our petroleum products and chemicals businesses are now combined into a single new subsidiary, Phillips 66 Company. Among many other benefits, this change improves productivity by merging staff functions and enables us to take a unified approach to all of our processing and marketing activities.
- We ran our U.S. refineries at near capacity. During a year in which refinery utilization averaged approximately 80 percent throughout the industry, we were able to operate our three U.S. refineries at 97 percent of capacity. In addition, we

continue to process a higher-than-average percentage of natural gas liquids at our refineries. This enables us to lower raw material costs and produce a greater percentage of high-value products, such as unleaded gasoline.

- We increased our share of the gasoline market within our 34-state marketing area. Our gasoline sales — excluding product exchange agreements — increased by 6 percent during the year, compared with an industry increase of 1 percent. This increase resulted in part from a successful strategy of moving into selected marketing territories as other companies adjusted and consolidated their areas of operation.
- We achieved record sales in our plastics business. Increases in demand were particularly strong for Driscopipe, our polyethylene plastic pipe, and for Ryton, our high-strength engineering plastic.
- We created a new organization to speed our discoveries into the marketplace. This new group will help find commercial applications and markets for new products and processes developed by Research and Development — in the fields of advanced composite materials and biotechnology, for example.

And no summary of our accomplishments in 1985 would be complete without mentioning our performance in the area of safety.

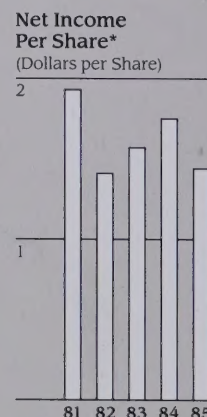
Our overall safety record has been improving for several years. We have reached some major safety milestones and now rank number two among major oil companies.

Important management changes during 1985 included the election of C.J. Silas as chairman and chief executive officer, succeeding Wm. C. Douce, who reached normal retirement age. Glenn A. Cox, formerly executive vice president and the company's chief financial officer, replaced Silas as president and chief operating officer.

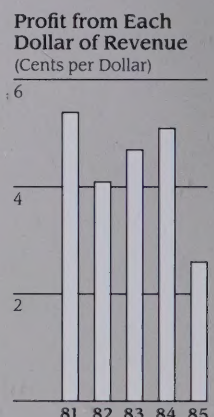
Strategic Objectives

The volatility of oil prices over the past decade has had an unsettling effect on long-range planning in the petroleum industry. Uncertainty about the direction, magnitude and timing of price changes has further complicated the always difficult challenge of finding the proper balance between short-term considerations and long-term objectives.

The drop in oil prices we've experienced since January has been unprecedented. And until the future direction of prices is in clearer focus, we are going to be very cautious about making long-term commitments or undertaking major new projects. Our tentative plans to spend approximately \$1.4 billion on capital projects in 1986 have been revised downward, and we are currently budgeting only \$1 billion in capital spending. However, we may well spend even less than this budgeted amount if prices remain at seriously depressed levels. Our ongoing asset sale program, combined with our option to lower operating costs and capital spending, give us



*Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.



additional flexibility to deal with the severe economic pressures affecting our industry.

For the near term, we intend to put a high priority on debt reduction and projects which will generate early returns and enhance our cash flow. Our strong exploration program and our emphasis on reserves replacement over the past few years have given us a solid inventory of discoveries and producing properties that we can profitably develop. Our downstream activities, which we have significantly restructured, consist of low-cost, efficient businesses that are strong competitors in their markets.

For the longer term, we will shift resources as they become available into high-potential exploration projects and other investment opportunities that take advantage of our special strengths and skills. We have demonstrated in the past an ability to enhance our competitive position through technological innovation, and this ability will be even more critical to our success in the future.

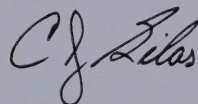
Outlook

Oil prices are only one of the uncertainties we face in 1986. Proposals have been advanced, for example, that would significantly increase the tax burden on American businesses. While reduction of the federal deficit is certainly a worthwhile objective, it would be unfortunate to tax away money that American companies would otherwise use to create jobs and more effectively meet the challenge of foreign competition. It would be even more unfortunate for the government to raise taxes — on businesses or individuals — without first battling its own high costs and inefficiencies with the same vigor as the private sector.

However, there are encouraging signs. Economic indicators are generally positive. Inflation is low and interest rates have moderated. The negative effect of lower oil prices on our oil and gas production businesses may well be offset to some degree by improvements in our chemicals businesses, many of which will benefit from a general economic upswing.

Looking back to the events of the past year, we would like to thank our shareholders for their loyalty and support. And we would also like to express our appreciation for the skill, energy and dedication of the men and women of Phillips. These men and women, many of them shareholders themselves, are committed to the success of our company and the improvement of its value as an investment. Because of them, we look to the future with confidence.

For the Board of Directors,



C.J. Silas
Chairman and
Chief Executive Officer



Glenn A. Cox
President and
Chief Operating Officer

March 10, 1986

The main thrust of Phillips strategy is to develop recent discoveries that can come on stream quickly and yield near-term cash flow. At the same time, the company intends to pursue a selective exploration program that will enable it to maintain its position as a vigorous competitor in the U.S. and international arenas. In keeping with this strategy, approximately 65 percent of the company's 1986 capital expenditures budget will go to Exploration and Production. Most of these expenditures will be used to develop recent discoveries — such as those offshore California, in the Gulf of Mexico and in the U.K. North Sea — and to maintain high levels of production from already producing properties.

1985 Overview

Net income from Exploration and Production was \$444 million in 1985, compared with \$495 million a year earlier. Although crude oil and natural gas production was up, lower crude oil prices and foreign currency transaction losses contributed to the reduction in earnings.

Expensed exploratory costs and leasehold impairment declined 22 percent during the year. Of this, dry hole costs were 24 percent lower.

U.S. and foreign taxes continued to be a major expense. In 1985, 75 cents out of every dollar of pretax income went for income taxes, compared with 71 cents in 1984. Income taxes on the company's Norwegian operations were \$792 million, compared with \$743 million a year earlier.

Phillips participated in the completion of 127 exploratory wells during the year, 33 of which were productive.

In the United States, important discoveries were made in the Gulf of Mexico and the northern part of California's Santa Maria Basin. Outside the United States, discoveries were made in the South China Sea, Indonesia and the U.K. North Sea.

Asset Sales

In order to reduce debt, Phillips offered a number of oil and natural gas properties for sale, many of which were acquired through the purchases of General American Oil Company in 1983 and Aminoil in 1984.

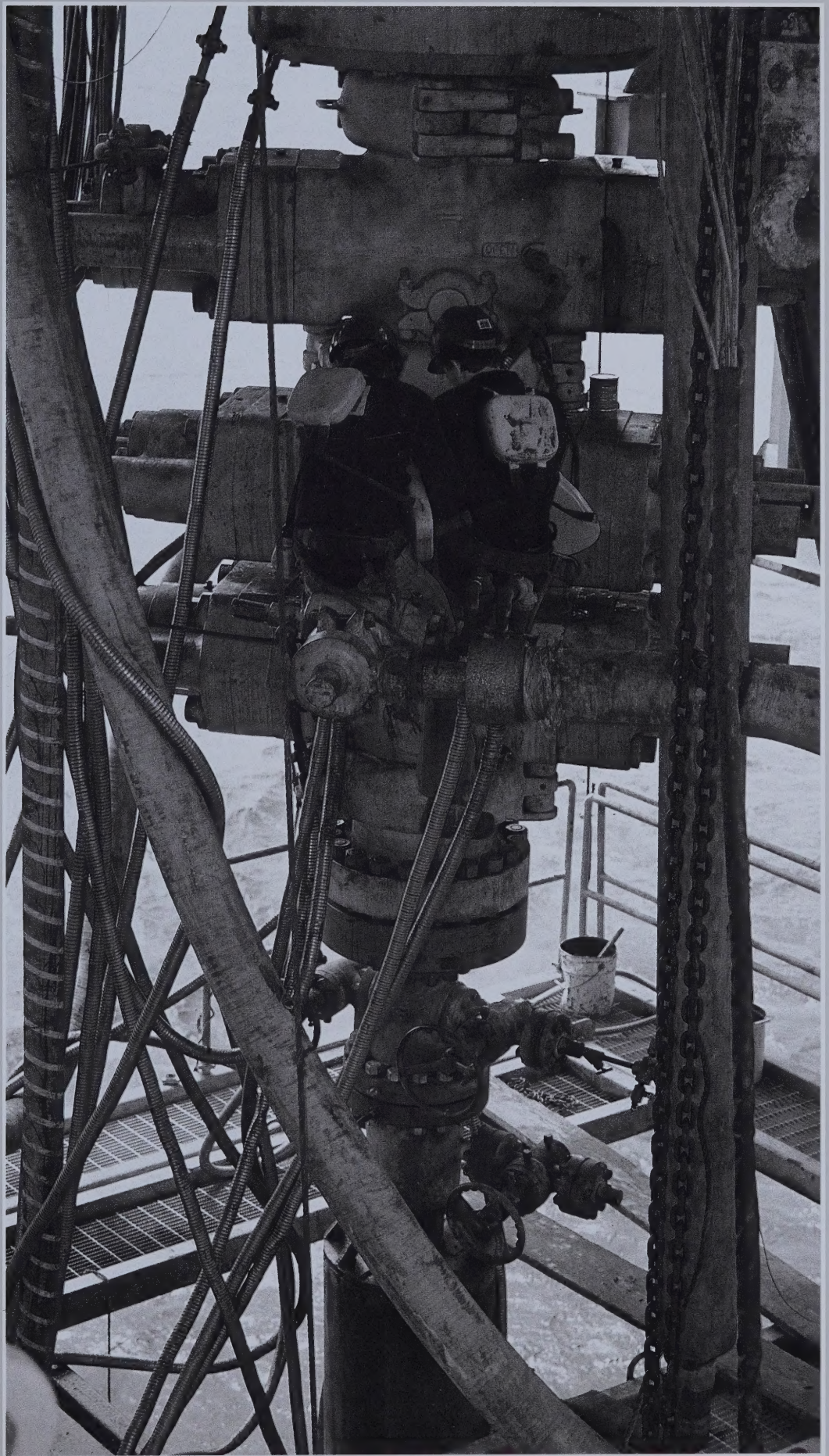
At the end of the year, the company had sold — or contracted to sell — its interests in selected proved and unproved properties in the Netherlands sector of the North Sea, Alaska, California, West Texas, Wyoming, Arkansas, Montana, Colorado, the Gulf of Mexico and the U.K. North Sea. These sales are expected to reduce proved hydrocarbon reserves by 4 percent and production by 4 percent.

Reserves

Estimated worldwide proved reserves of crude oil had a net reduction of 3 percent in 1985, decreasing to 901 million barrels. Proved reserves of natural gas liquids showed a net decrease, declining 9 percent to 162 million barrels. At the end of the year, worldwide proved reserves of natural gas were 4.88 trillion cubic feet, a net decrease of 20 percent from the same period a year earlier. The decline in worldwide natural gas reserves was primarily the result of a reinjection program to reduce subsidence in the Ekofisk field in the Norwegian North Sea, as well as from the sale of certain natural gas properties. A significant portion of the Norway gas now being reinjected could be included in proved reserves if a nitrogen-injection project is later initiated for the Ekofisk field.

Estimates of proved reserves are based upon reservoir information, technology and economics available at the end of the year. Such reserves, however, cannot be measured precisely. Adjustments are made to reflect changes in economic conditions, results of drilling and production and the technical reevaluation of reservoirs.

A drill bit probes deep into the Gulf of Mexico as these workers keep the rig in smooth running order. The Gulf of Mexico is a high priority area for developing fields that can generate near-term cash flow. In 1985 Phillips drilled or participated in seven oil and gas discoveries in the Gulf and acquired 13 federal leases in these waters.



Prices The continued oversupply of crude oil was the leading factor in lower oil prices for the year. In the United States, Phillips average price for crude oil was 6 percent below the previous year, and overseas prices were 7 percent lower.

The average natural gas price, however, was 6 percent higher in the United States and 4 percent higher overseas.

United States U.S. crude oil production rose 14 percent during the year. This was primarily the result of added production from Aminoil properties purchased in late 1984, as well as from a development program in the mature producing regions of the country. Because of Aminoil, the company's U.S. natural gas production also showed an increase, rising 4 percent from the previous year.

Capital expenditures in the United States were \$469 million. Expensed exploratory costs and leasehold impairment totaled \$321 million, down 27 percent from 1984.

In 1985 the company completed – or participated in the completion of – 1,585 exploratory and development wells, a 13-percent increase from 1984.

During the year, the company concentrated on developing recent discoveries offshore California and in the Gulf of Mexico.

Offshore California, the most important development project was the Point Arguello field in the Santa Maria Basin. The first production platform was installed at the field late in the year, and a second platform is scheduled to be in place in mid-1986. Phillips has a 40-percent interest in one platform and a 50-percent interest in the other. Production from the field is expected to begin in mid-1987 and to reach a rate of 57,300 barrels of oil a day and 53 million cubic feet of natural gas a day in 1989. The company and its co-venturers have signed agreements to build a 200,000-barrel a day crude oil pipeline and a 120-million cubic feet a day natural gas pipeline to onshore facilities in California. The pipeline not only will carry production for Phillips and its co-venturers but production from other fields in the area as well.

Further north in the Santa Maria Basin, the company made a second oil discovery on the Spruce prospect, located adjacent to an oil field that is under development by another company. Seismic and reservoir studies are under way to determine the commerciality of the discoveries. Phillips has a 50-percent interest and is operator.

Also in California waters, the company is evaluating the Rocky Point field for future development. The field is located just northeast of Point Arguello. Phillips has a 44-percent interest.

Overall, Phillips has interests in 40 federal leases offshore California.

Another area that will continue to provide near-term cash flow is the Gulf of Mexico, where the company is developing important natural gas discoveries offshore Louisiana in the West Cameron and South Timbalier areas. In total, Phillips participated in seven oil and natural gas discoveries in the Gulf in 1985 and acquired interests in 13 federal leases in those waters.

At the same time the company is working to develop recent discoveries, it also is working to maintain high production levels from existing fields. During the year, Phillips participated in the completion of 955 productive development wells in Texas, Oklahoma, Kansas and Wyoming. In addition, 433 secondary and tertiary enhanced oil recovery projects were under way at the end of the year. These projects account for about one-third of the company's daily U.S. production.

In Alaska, an equity redetermination caused the company's share of production from the Prudhoe Bay field to be reduced in September to 16,000 barrels of oil a day for a two-year period, with production returning to a level of about 25,000 barrels a day in late 1987. The company is contesting the redetermination.

This rig drills in New Mexico, one of the mature producing areas of the country where Phillips is looking to increase production. About one-half of the company's daily U.S. production comes from older fields, most of them located in Oklahoma, Texas, Kansas and New Mexico.



Norway

The Greater Ekofisk Development in the Norwegian North Sea accounted for 21 percent of the company's total petroleum production in 1985. During the year, the company's 37-percent share of crude oil production averaged 62,700 barrels a day, down 13 percent from 1984. Natural gas liquids production averaged 12,000 barrels a day, the same as the previous year. And production of natural gas averaged 327 million cubic feet a day, down 10 percent.

One factor behind lower crude oil and natural gas production was the natural decline that occurs as fields begin to mature.

However, natural gas production also was affected by a gas-reinjection program to reduce the subsidence rate at the Ekofisk field, one of the seven fields that make up Greater Ekofisk. The seafloor has subsided about nine feet since production from the field began in 1971. During the year, the company began injecting approximately one-fourth of its natural gas production into the reservoir to stabilize pressure and reduce further subsidence in the field. Gas sales will continue to be affected by the reinjection program at least through 1986.

For the future, the company is considering several other alternatives to reduce subsidence, including a nitrogen-injection program. Injecting nitrogen not only would help alleviate subsidence but also could increase the volume of hydrocarbons ultimately produced from the reservoir.

Phillips and co-venturers already have initiated a \$1.7 billion waterflood project to extend the producing life of the Ekofisk field. A water-injection platform is expected to be installed in 1986, with water injection beginning in 1987. The waterflood is expected to recover the equivalent of an additional 170 million gross barrels of crude oil over a 24-year period.

The company is profitably putting to use spare capacity in its Greater Ekofisk processing and transportation system. During the year, Phillips entered into agreements with other producers to process and transport their production to facilities in West Germany and the United Kingdom.

United Kingdom

The Maureen field in the U.K. North Sea continued to be a major contributor to crude oil production. For the year, Phillips 34-percent share of production averaged 23,700 barrels of oil a day, compared with 23,600 barrels a day in 1984.

South of Maureen is the J-block area, where significant amounts of oil and gas have been tested from multiple zones. Two more appraisal wells are planned in 1986 to evaluate the area further. Phillips has a 33-percent interest.

Off the southeastern coast of England, the company is moving ahead with the development of the Audrey natural gas field. Deliveries to the British Gas Corporation are scheduled to begin in 1988.

In 1985 the company's share of production from the Hewett-area natural gas fields averaged 55 million cubic feet a day, down 5 percent from 1984. Three development wells are planned in 1986 to increase production from these fields. Phillips has a 19-percent interest.

Other Producing Areas

Phillips share of production from Nigeria averaged 24,000 barrels of oil a day in 1985, up 14 percent from a year earlier. A new field was brought into production during the year which helped boost output. Production levels are expected to be enhanced further from a gas-injection program which will begin in late 1986.

Phillips share of production from the Espoir field offshore Cote d'Ivoire averaged 5,400 barrels of oil a day, up 2 percent from 1984. Phillips has a 57.5-percent interest in two production-sharing contracts covering the field. Early in 1986, the company was negotiating with the government for the production and sale of natural gas from Block B-1, located northwest of the Espoir field.

In Canada, Phillips share of production averaged 4,000 barrels of oil a day and 31 million cubic feet of natural gas a day. Oil production was down 6 percent from the previous year, and natural gas production was up 65 percent.

Net production from three fields in Egypt averaged 2,500 barrels of oil a day, compared with 2,200 barrels a day in 1984. The company expects to be able to increase production from the Umbarka field in 1986, when a pipeline connecting the field to the Western Desert Pipeline system will be completed. At the end of the year, negotiations were under way with the Egyptian government for a production-sharing contract covering 1.48 million acres. The area is adjacent to the Umbarka field.

Through the acquisition of Aminoil, Phillips acquired an interest in a service contract with the National Oil Company of Argentina in the Mendoza Field Complex. In 1985 net production averaged 4,500 barrels of oil a day.

Other Exploratory Areas

Early in the year, Phillips and a co-venturer made an oil discovery in the South China Sea offshore the People's Republic of China. Two appraisal wells also were successful, and the company now is evaluating the economic potential of the discovery. Additional exploratory drilling is planned in late 1986 on a second block, covering about one million acres and located immediately south of the discovery area. Phillips has a 50-percent interest and is the operator.

Elsewhere in the Far East, the company has a 15-percent interest in two oil fields in the Kakap block offshore Indonesia. Production from one field is expected to begin in 1986 and reach a rate of 3,500 net barrels a day in 1987. Development plans for the second field were in progress at the end of the year. Onshore Indonesia, Phillips participated in a successful exploratory well on Tarakan Island. Appraisal drilling and additional exploratory wells are planned through 1987. Phillips holds a 25-percent interest in this discovery well.

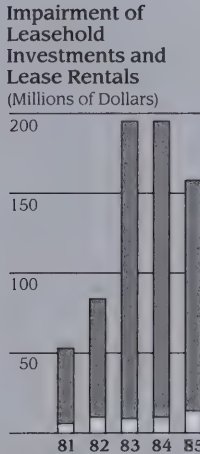
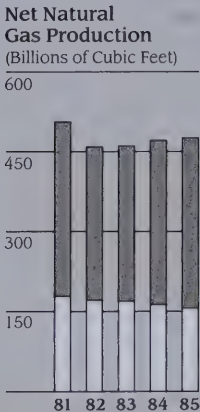
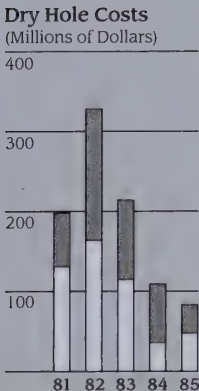
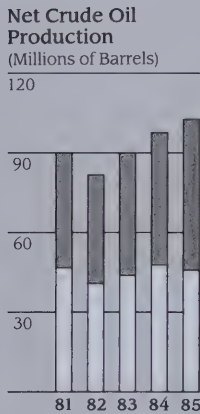
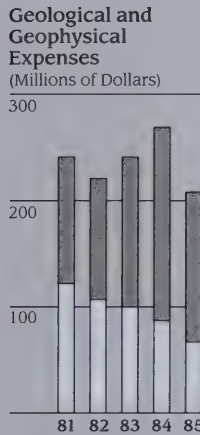
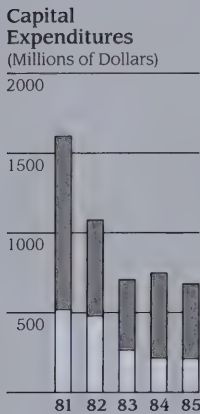
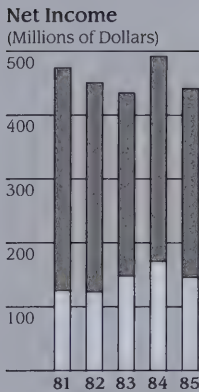
Early in 1986, the company began drilling its first exploratory well in waters off the coast of Denmark. Phillips has interests in leases onshore and offshore the country totaling 199,400 net acres.

A roustabout works on a rig drilling for Phillips and a co-venturer offshore the People's Republic of China. In 1985 Phillips made its first oil discovery in these waters and completed two successful appraisal wells.



Exploration and Production Statistics

■ United States
□ Outside U.S.



Gas and Gas Liquids is a traditional area of strength for Phillips. Not only does this business provide a steady stream of feedstock to the company's downstream operations, it also provides strong net income and cash flow.

This business takes natural gas purchased from others and produced from the company's own exploration and production reserves and processes that gas in one of its 63 wholly or partly owned extraction plants. The natural gas liquids (ethane, propane, butanes and pentanes) are extracted and transported to Phillips downstream facilities where they are used as feedstock or sold to outside customers. The remaining residue gas is used as fuel in company operations or sold to others.

In looking to the future, Phillips expects its natural gas liquids production to continue to be one of the top in the industry. The company has extensive reserves, well-situated gathering systems and efficient processing facilities. In 1986 Phillips will devote about 10 percent of its capital expenditures budget to Gas and Gas Liquids. Most expenditures will be directed toward replacing gas reserves in areas near the company's existing gathering and processing facilities.

1985 Overview

Earnings from Gas and Gas Liquids were \$152 million in 1985, compared with \$178 million in 1984. The decline was primarily the result of lower sales prices for natural gas liquids, residue gas and liquefied natural gas.

Phillips remained the largest producer of natural gas liquids in the United States, with production of 192,100 barrels a day. This is a 7-percent increase over 1984.

Asset Sales

During the year, the company sold — or contracted to sell — two gathering systems in Texas and Colorado, a gas-treating facility in Arkansas and its Williston, N.D., gathering system and plant. The sale of these properties had minimal impact on the company's overall gas gathering and processing capability.

Reserves

In addition to the large natural gas reserves that have been developed through the company's own exploration and production program, Phillips also has access to other large reserves of natural gas and natural gas liquids through purchase contracts and processing or exchange agreements. At the end of the year, the company's estimated U.S. reserves of natural gas available through contracts and agreements totaled 2.47 trillion cubic feet, compared with 2.14 trillion cubic feet at the end of 1984. U.S. reserves of natural gas liquids available under natural gas purchase contracts and processing agreements were an estimated 343 million barrels at the end of 1985, compared with 366 million barrels the previous year.

Gas Gathering and Processing

The company processed 2.2 billion net cubic feet of natural gas a day in 1985, compared with 1.9 billion cubic feet the previous year.

During the year, the company signed agreements giving it an additional 270 million cubic feet a day of processing capacity in the Sweeny, Texas, area. The added capacity will be used to extract natural gas liquids from gas in the Seagas pipeline system, which extends from Oklahoma to the Texas Gulf Coast.

Phillips also expanded its gathering systems in Oklahoma, Wyoming and West Texas. A cryogenic extraction plant, with a capacity of 75 million cubic feet of gas a day, was started up near Sherman, Texas. The plant replaces a smaller, older facility.

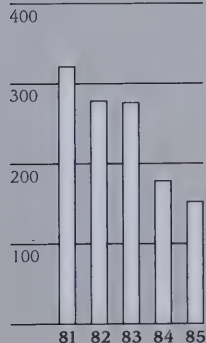
Although flat demand industrywide and lower residue gas prices negatively affected Gas and Gas Liquids, they provided the opportunity to acquire future gas production at a lower cost. For the year, purchases of natural gas averaged 1.9 billion cubic feet a day, an increase of 9 percent over the previous year.

This new cryogenic extraction plant near Sherman, Texas, was started up during the year. Phillips remained the largest producer of natural gas liquids in the United States, with production in excess of 190,000 barrels a day.

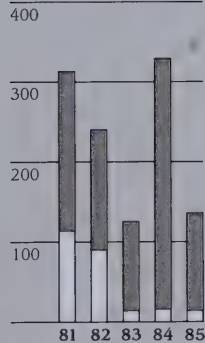


Gas and Gas Liquids Statistics

Net Income
(Millions of Dollars)

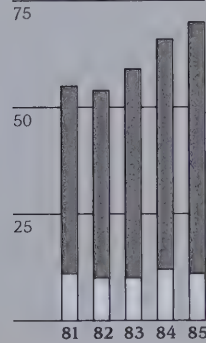


Capital Expenditures
(Millions of Dollars)



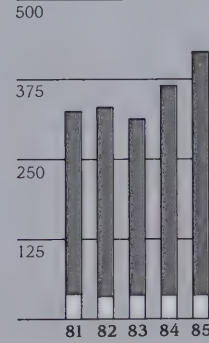
■ Natural Gas Systems
□ NGL Extraction and Helium Plants

U.S. Net NGL Plant Production
(Millions of Barrels)



■ Production from Purchased Gas
□ Production from Leasehold Gas

U.S. Natural Gas Sales
(Billions of Cubic Feet)



■ Residue Gas
□ Liquefied Natural Gas

To increase efficiency, the company consolidated the operations of its downstream businesses — Petroleum Products and Chemicals — into a single subsidiary, Phillips 66 Company. The subsidiary will serve customers with products ranging from raw materials to motor fuels and plastics.

The consolidation is a natural fit since Petroleum Products supplies approximately two-thirds of Chemicals raw material and product needs in the United States. Furthermore, productivity is expected to be enhanced by integrating staffing needs. Phillips 66 Company will be responsible for about \$3.1 billion in assets.

This station near Fort Gibson, Okla., exemplifies the many ways the company is working with its independent marketers to enhance the Phillips 66 brand. As a result of this effort, sales of Phillips 66 branded motor fuel have increased substantially over the past two years.



Petroleum Products was the company's second largest contributor to net income in 1985. The company's three U.S. refineries ran near capacity, and an aggressive marketing program resulted in higher sales.

For the future, the company plans to continue to improve efficiencies by producing high-value products from lower grade crude oils and by continuing to run its refineries at capacity. As the industry continues to restructure and competitors move out of Phillips marketing territory, the company intends to recruit marketers who can enhance market share in select locations.

In 1986 Phillips expects to devote about 7 percent of its capital expenditures budget to Petroleum Products, about the same level as the past year.

1985 Overview

Despite intense competition industrywide, Petroleum Products achieved significantly higher earnings. In 1985 these operations had net income of \$170 million, compared with \$97 million in 1984.

A number of factors contributed to the earnings increase, including higher motor fuel margins, lower operating expenses and higher sales volumes. Expenditures made in previous years to improve operating efficiencies also benefited earnings, as did an outstanding safety record.

Excluding product exchange agreements, U.S. sales of petroleum products increased 13 percent during the year, while total U.S. industry demand decreased slightly. Sales of automotive gasoline were 6 percent higher than in 1984, compared with an increase of 1 percent for the industry.

Sales of distillates were up 7 percent for the year, while average sales for the industry rose only 1 percent.

U.S. sales of natural gas liquids products increased 23 percent from 1984. This was primarily the result of increased demand for natural gas liquids products by the petrochemicals industry and a vigorous marketing effort for propane.

Combined sales volumes of turbine fuel and aviation gasoline were 4 percent higher for the year.

Asset Sales

At the end of the year, the company had sold — or was in the process of selling — its West Coast marketing terminals, its interests in an equity pipeline, an East Coast marketing subsidiary and a bitumen refinery located in Great Britain. These sales are expected to have minimal impact on net income.

Feedstock Supplies

Combined runs of crude oil and natural gas liquids processed in company refineries were up slightly in 1985. U.S. crude oil accounted for 88 percent of the company's crude runs, up 3 percent from 1984. Natural gas liquids accounted for 40 percent of total refinery runs, the same as the previous year. For Phillips, natural gas liquids are a major factor in reducing raw material costs and producing more high-value products from each unit of throughput.

Refining

Phillips operated its U.S. refineries at 97 percent of capacity during the year, compared with an industry average of about 80 percent.

The cost of crude oil delivered to the company's three U.S. refineries was 7 percent lower than in 1984, reflecting the general decline in crude oil prices and greater reliance on lower priced spot-market purchases. High-sulfur crude oil accounted for 62 percent of the crude processed at the company's refineries.

The cost of natural gas liquids also decreased 9 percent during the year. Natural gas liquids runs averaged 195,000 barrels a day, slightly higher than 1984.

Engineer Dwain Parker looks out over a small part of the company's Sweeny, Texas, refinery, one of the most modern and efficient refineries in the country. In today's highly competitive market, refineries like this one maximize returns by processing high-sulfur crude oils into high-value transportation fuels.



The company's safety program continued to be a major contributor to improved efficiencies. Early in 1986, Phillips U.S. refineries achieved 9 million employee-hours without a disabling injury, the best safety record in the refining industry.

Marketing

The company continued to work with its independent marketers to promote the Phillips 66 brand. In order to establish a uniform marketing image, the company offered marketers assistance in the areas of station design and operation.

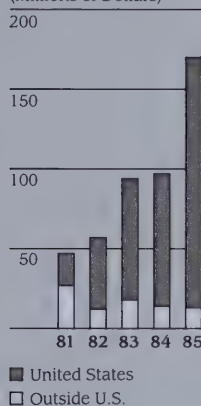
The company also continued to evaluate all branded stations for appearance and service. Stations that did not meet certain standards — about 4 percent of the company's total branded stations — had the shield removed.

As part of a brand-improvement program that began in 1983, the company had completed 59 new and remodeled company-owned service stations at the end of 1985. These stations are located in metropolitan areas where there is opportunity to enhance the company's visibility. They not only offer a good return on investment but also serve as models for independent marketers in the area.

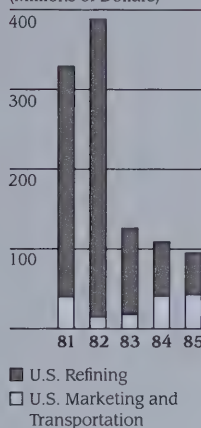
Phillips continued to maintain a good relationship with its marketers and was named the best overall supplier to independent marketers by the Petroleum Marketers Association of America.

Petroleum Products Statistics

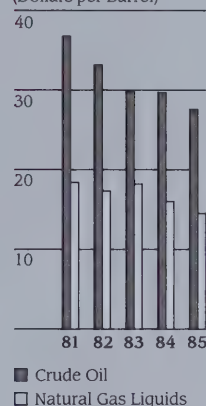
Net Income
(Millions of Dollars)



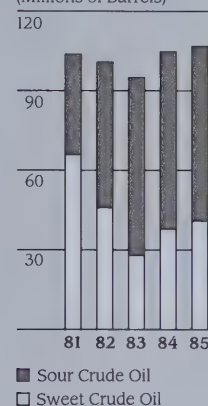
Capital Expenditures
(Millions of Dollars)



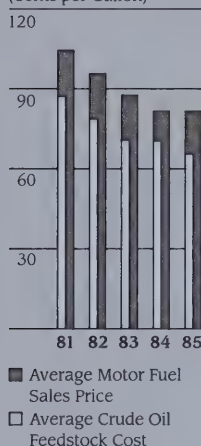
Average Cost of Refinery Feedstocks
(Dollars per Barrel)



Refinery Crude Oil Runs — Sweet to Sour
(Millions of Barrels)



Crude Oil Feedstock Cost to Motor Fuel Sales Price
(Cents per Gallon)



Feedstocks Processed and Products Produced

Average Percent

	1985	1984
Feedstocks Processed		
Domestic crude oil	52%	50
Imported crude oil	7	9
Natural gas liquids	40	40
Miscellaneous hydrocarbons	1	1
	100%	100
Products Produced		
Automotive gasoline	36%	36
Aviation fuels	7	7
Chemical feedstocks	15	14
Distillates	17	18
Consumer liquefied petroleum gas (LPG)	16	16
Other products	9	9
	100%	100

Refinery Crude Oil and Natural Gas Liquids Capacities and Runs — Thousands of Barrels Daily

	Crude Oil		Natural Gas Liquids	
	Capacity	Runs	Capacity	Runs
1985				
Sweeny, Texas	175	169	86	88
Borger, Texas	100	99	95	86
Woods Cross, Utah	25	24	—	—
Conway, Kansas	—	—	42	21
	300	292	223	195
1984				
Sweeny, Texas	175	169	81	80
Borger, Texas	95	97	95	93
Woods Cross, Utah	25	22	—	—
Conway, Kansas	—	—	42	20
	295	288	218	193

Phillips has been streamlining its chemicals operations for several years and now is focusing its efforts on business lines where the company is firmly established, where it has strong research and technical expertise, and where there is opportunity for future growth.

A major strength upon which the company continues to build is its secure raw material position. About two-thirds of Chemicals U.S. feedstock requirements are supplied within the company. As these raw materials are upgraded into finished products, value is added with each step of processing.

The company intends to maintain a competitive position in its commodity polymers, olefins and aromatics, as well as polypropylene fibers, plastic pipe, sulfur chemicals, hydrocarbon solvents and propellants. In addition, the company plans to selectively develop products and markets for catalysts, oil field chemicals, specialty chemicals and specialty plastics, such as engineering polymers.

In 1986 about 6 percent of the capital expenditures budget will go to the company's chemicals operations.

1985 Overview	Chemicals earned \$128 million in 1985, the same as in 1984. Although product prices were lower, earnings benefited from lower feedstock costs and higher sales volumes for most plastic resins and other products. Higher plant utilization rates and improved operating efficiencies also helped net income.
Asset Sales	During the year, the company announced that it was offering its fertilizer business for sale. The sale of this business is expected to have only a minimal impact on Chemicals net income. Over the past three years, Phillips has sold or shut down more than a dozen operations that no longer fit with Chemicals long-term strategy.
Petrochemicals	Prices for feedstocks and products were down for both olefins and aromatics during the year. However, sales volumes for olefins increased, and they remained essentially the same for aromatics. Phillips is one of the lowest cost producers of ethylene, an olefin that is a major feedstock in the manufacture of plastics. Aromatics are used in the manufacture of synthetic fibers for clothing and home furnishings.
Chemicals and Catalysts	Although the number of drilling rigs operating worldwide fell during the year, revenues were essentially the same for Drilling Specialties Company, which markets and manufactures drilling mud additives and other oil field chemicals. Sales volumes were up for the company's wholly owned subsidiary, Catalyst Resources Inc., which manufactures polymerization catalysts for the plastics industry. A major expansion of the company's Bayport, Texas, plant, which was completed late in the year, will enable the company to increase sales in the polyolefins market. Worldwide sales of specialty chemicals were flat for the year. Sales volumes for carbon black were lower in the United States, reflecting reduced industry demand. However, sales volumes increased overseas.
Plastics	The company's plastic resins business had record sales volumes in 1985. Polypropylene production facilities operated at near capacity levels, and an engineering polymer plant at Borger, Texas, increased production by 19 percent over 1984. During the year, a joint-venture pilot plant utilizing Phillips engineering polymer technology began operating in Japan. Phillips manufactures four major plastic resins: Marlex, produced by the world's most widely used high-density

A major expansion of this catalyst manufacturing facility was completed in 1985 near Bayport, Texas. Selective expansions like this are expected to continue in areas where the company has technical expertise, a good market position and opportunity for future growth.



A major expansion of the company's polypropylene facilities will get under way in 1986 here at the Houston Chemical Complex. In light of falling oil prices, the company is moving to improve earnings by upgrading more raw materials into higher value chemical products.



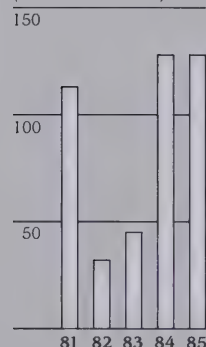
polyethylene process; Ryton, an engineering plastic with heat and corrosion resistance; K-Resin, a clear plastic used in disposable containers and packaging, and polypropylene, used in synthetic fibers and other plastic products.

Phillips Driscopipe Inc. also had higher sales volumes for the year. Demand continued to grow for the company's polyethylene pipe in the gas distribution, housing and fiber optics businesses.

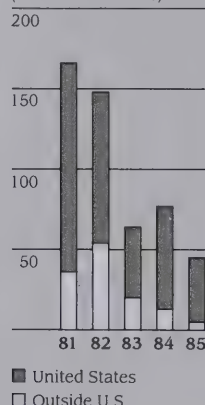
The company's wholly owned subsidiary Phillips Fibers Corporation had record sales volumes for the year. Demand continued to be strong for the company's polypropylene fiber, especially its civil engineering fabrics.

Chemicals Statistics

Net Income
(Millions of Dollars)



Capital Expenditures
(Millions of Dollars)



Operating Revenues

	Millions of Dollars				
	1985	1984	1983	1982	1981
Basic petrochemicals and specialty chemicals	\$1,097	1,092	998	935	1,010
Plastic resins	625	638	572	508	476
Rubber chemicals	187	214	234	308	309
Consumer products	91	93	133	266	302
Fertilizers	80	92	95	139	128
Synthetic fibers	139	127	120	97	97
Other sales and services	47	95	103	103	148
	\$2,266	2,351	2,255	2,356	2,470

New challenges were created for Phillips people as the company continued to consolidate and streamline its activities. A major thrust of this effort was to remove layers of supervision and put more decision-making responsibility at the level where operations are carried out. This was accomplished largely through the company's two early retirement programs. Many employees who chose to retire early were in supervisory positions and were not replaced.

Employment

At the end of 1985, Phillips employed 25,300 people, 14 percent fewer than the previous year and 27 percent fewer than in 1981, when the company began its restructuring effort. A major part of the personnel reduction came from two early retirement programs offered to employees age 55 years and older. Approximately 2,600 employees took advantage of these programs. Most other reductions were the result of normal attrition. There were no general layoffs.

At the end of the year, women and minorities accounted for 15 percent of the company's U.S. work force. Women held 4 percent of the company's managerial jobs, and minorities held 6 percent.

Employee Participation

Although the company had lower employment during the year, first-year tangible savings from employee suggestions were \$21 million, about the same as in 1984 when Suggestion Plan savings set a record. In 1985 almost 3,900 awards were paid for suggestions that reduced costs and improved productivity. The total dollar amount paid to employees for their suggestions was \$1.3 million.

Employees also contributed to efficiency and profitability through the company's 120 Participative Action Teams. These teams, which meet regularly to solve work-related problems, encourage innovation and work to improve understanding of business operations and management problems. Since the program began in 1981, Participative Action Teams have reduced costs by more than \$7 million.

Safety

Phillips safety record moved up to second place among major oil companies. Lost-workday cases were 13 percent lower for the year, with a rate of one lost-time accident per 400 employees. An accident at a natural gas liquids extraction plant resulted in one death during the year.

The company's refining operations had the best safety record in the industry. In addition, vehicle accidents were reduced 48 percent during the year, and property losses due to fire and explosions were reduced 29 percent.

Curtis B. Wood, a stillman at the Borger, Texas, refinery received one of four \$25,000 suggestion awards presented in 1985. First-year tangible savings from employee suggestions were \$21 million for the year.



A major effort was made during the year to hasten the time it takes to bring discoveries to the marketplace. Part of this effort included the establishment of a new organization to develop markets for products with sophisticated, high-technology applications.

Research and Development continued to concentrate on developing new products and processes to enhance the company's existing businesses. Long-range research was centered on biotechnology and advanced composites, both of which are areas where the company can build on past research accomplishments.

Exploration and Production

Researchers continued to develop new methods for lowering petroleum exploration and production costs. Improvements were made in "fingerprinting" crude oils by using advanced technology to characterize organic matter. Through this technology, scientists can determine whether the oils produced from different wells are from the same source. This information can be used to develop reservoirs more effectively.

A new method of core orientation was developed that yields valuable reservoir information for planning the location of wells. Phillips new technology, which is one-half the cost of conventional technology, uses magnetic information to indicate fracture orientation. The new technology is being used in fracture analysis studies for the company's waterflood of the Ekofisk field in the Norwegian North Sea.

At the end of the year, field tests were under way to measure the effectiveness of new water-soluble polymers in increasing oil recovery from reservoirs undergoing waterflooding. These gel-like polymers can withstand high-temperature, high-salinity environments and are expected to be used in areas like the North Sea and onshore California.

Phillips-developed seismic technology continued to provide more accurate estimates of subsurface rock structures and possible petroleum reserves. In addition, the company developed computer technology that increased the speed and accuracy of processing seismic data.

Petroleum and Chemical Processes

To aid refining operations, a computer model program was developed and installed at the Borger and Sweeny, Texas, refineries to predict how processing equipment will perform with various combinations of crude oils, catalysts and operating conditions.

Phillips has developed a hazardous waste incinerator, the first permitted by the federal government. During the year, a more efficient system was developed for feeding solid waste into the incinerator. Efforts are now under way to further improve the handling of solid waste.

Research continued to enhance the efficiency and profitability of the company's plastics and petrochemicals businesses. During the year, new catalysts were developed for these operations, and catalyst production facilities were expanded.

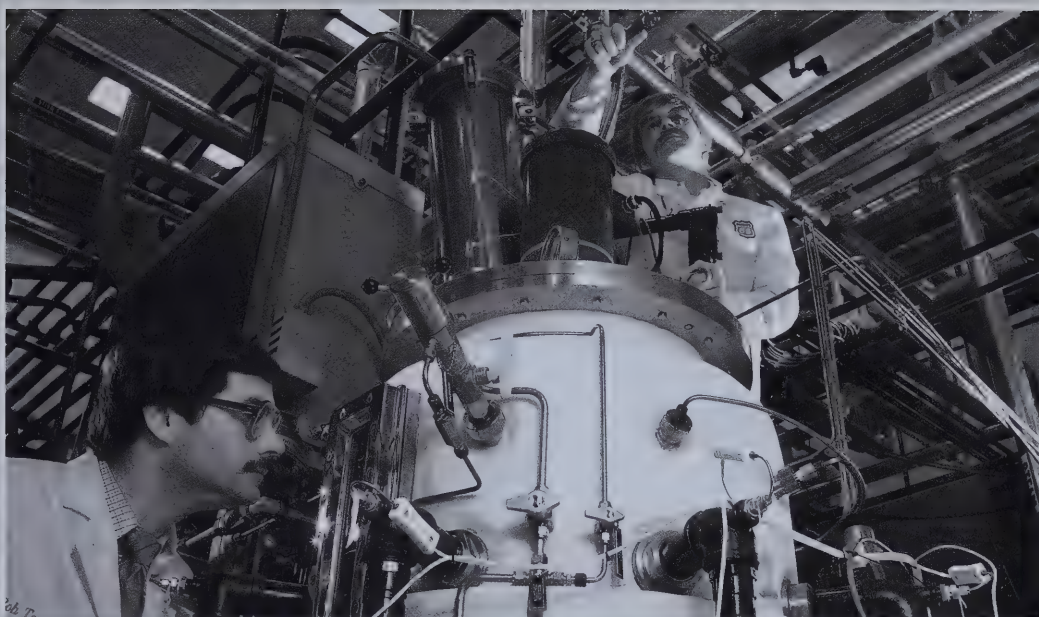
Polymers and Materials

To support the company's plastics business, Phillips researchers developed new high-density polyethylene resins that have superior stability and strength. These materials are expected to find wide use in bottle and film fabrication. A process for manufacturing a K-Resin polymer with improved chemical and breakage resistance also was developed for medical and packaging markets.

A pilot plant began producing a new line of polyarylene sulfide resins to use as engineering plastics and in new composite materials. These resins will perform at higher temperatures than materials now available.

Also in 1985 a semicommercial plant began manufacturing a variety of synthetic pheromones for controlling insects that damage cotton, tobacco and corn crops.

Biotechnology pilot plant supervisor Bob Torregrossa, left, and pilot plant operator Gary Jackson are part of a team working to develop new fermentation processes. Efforts so far have resulted in superior techniques that allow biological drugs and chemicals to be produced more efficiently than other processes now being used.



High Technology

A line of plastic composites developed by Phillips researchers was selected by "Research and Development" magazine as one of the world's most significant new technical products. These composites — often called synthetic metals — combine Phillips Ryton polyphenylene sulfide polymer with glass, carbon or aramid reinforcing fibers. These new composites are replacing metals in demanding applications in the petroleum, chemical, defense and aerospace industries.

Building on its long-term research in the area of fermentation technology, Phillips has developed superior techniques that allow biological drugs and chemicals to be produced more efficiently than other processes now available. During the year, the company signed a research contract with The Wadley Institutes to use Phillips technology to produce a drug for the potential treatment of cancer. The company is also working with major pharmaceutical companies to demonstrate its technology for producing other drugs and chemicals. During the year, a limited partnership was formed with the Baylor College of Medicine to support the commercialization of new diagnostic tests for the detection of cancer.

Patents

Phillips received 329 U.S. patents and 196 foreign patents during the year. At the end of 1985, the company held 5,529 active U.S. patents, the most held by any oil company. Licensing revenue was down 11 percent from 1984.

Phillips places a high priority on providing support to the communities where it does business. In 1985 the company provided \$9 million in financial assistance to organizations involved in youth, civic, cultural, educational, health and welfare activities.

Community Involvement

Amateur swimmers and divers continued to benefit from the company's support of these two sports. Phillips has been national sponsor of United States Swimming since 1973 and United States Diving since 1979. As part of this support, the company sponsored clinics and national championships for young people during the year.

Educational Support

Phillips provided \$6 million to education and educational films in 1985. Of this, more than \$1 million was paid to some 380 colleges and universities through the company's Matching Gift Plan. Under the plan, the company contributes \$2 for every \$1 donated by an employee, retiree or director. The maximum amount matched is \$5,000 a year.

Late in 1985, the company began distributing its newest educational film series, "The Challenge of the Unknown," to schools across the country. The seven-part series is designed to encourage young people to study and enjoy mathematics. The series was developed for students in elementary, junior and senior high school math classrooms and includes teaching materials for instructors.

Seeing an area where corporate support was needed, the company began sponsoring educational films in 1976. The first film series, "American Enterprise," examined the U.S. economic system, and a second series, "The Search for Solutions," was designed to encourage the study of science. The two series are the most widely viewed educational films in the country and have been seen by approximately 170 million students.

Environmental Protection

Capital expenditures of \$40 million were approved during the year to protect and improve the environment, and another \$117 million was spent to operate and maintain existing environmental control systems.

Chief among these projects was the installation of storm water systems at the Borger, Texas, refinery, the Puerto Rico Core petrochemical complex at Guayama and a terminal at Port Everglades, Fla.

An aspiring ballerina prepares for center stage at the Oklahoma Summer Arts Institute at Quartz Mountain. This is one of several programs Phillips helps sponsor to promote the artistic development of young people.

Energy Conservation

An equivalent of 1.9 million barrels of crude oil was saved in 1985 as a result of the company's energy conservation program. This is the 13th consecutive year that Phillips has reduced its rate of energy use. Since the program's inception in 1973, the company's rate of energy use has been reduced by 33 percent.



Contents

Management's Discussion and Analysis	26
Summary of Income	27
Common Stock Prices and Cash Dividends Per Share	29
Selected Financial Data	30
Report of Certified Public Accountants	30
Consolidated Statement of Income and Earnings Employed in the Business	31
Consolidated Balance Sheet	32
Consolidated Statement of Changes in Financial Position	33
Accounting Policies	34
Notes to Financial Statements	35
Selected Quarterly Financial Data	43

Oil and Gas Operations

Consistent with Financial Accounting Standards Board (FASB) Statement No. 69, "Disclosures about Oil and Gas Producing Activities," and in accordance with regulations of the Securities and Exchange Commission (SEC), the company is making certain disclosures about its oil and gas exploration and production operations. While this information was developed with reasonable care and disclosed in good faith, it is emphasized that some of the data are necessarily imprecise and represent only approximate amounts because of the subjective judgments involved in developing such information. Accordingly, this information may not necessarily represent the present financial condition of the company or its expected future results.

Oil and Gas Operations

Proved Reserves Worldwide	44
Capitalized Costs Relating to Oil and Gas Producing Activities	45
Costs Incurred in Oil and Gas Property Acquisition, Exploration and Development Activities	45
Oil and Gas Statistics	46
Results of Operations for Oil and Gas Producing Activities	48
Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Gas Reserve Quantities	49
Supplementary Information on Changing Prices	50
Five-Year Financial Review	52
Five-Year Operating Review	53

Management's Discussion and Analysis

February 13, 1986

Capital Resources and Liquidity

Financial Position

At December 31, 1985, Phillips working capital was \$34 million, an increase of \$777 million from the restated \$743 million deficiency in 1984. The working capital increase resulted primarily from decreases in notes payable (\$1.9 billion) and accounts payable (\$345 million), partly offset by decreases in cash and short-term investments of \$1.2 billion and inventories of \$229 million. The decline in cash and short-term investments was due primarily to the retirement of commercial paper. Inventories declined due mainly to lower quantities of refined products and materials and supplies. The decrease in accounts payable was due mainly to lower expenditure levels. The current cost of inventories at December 31, 1985, approximated \$665 million more than the stated value of inventories determined under the last-in, first-out (LIFO) method. This excess is not reflected in working capital.

Over the past three years, the company invested \$3.6 billion in properties, plants and equipment; paid dividends of \$1.3 billion, which included a \$281 million dividend of preferred stock; retired long-term debt of \$2.4 billion; purchased company stock totaling \$5.0 billion; required \$140 million for investment and other purposes; and purchased the net noncurrent assets of Aminoil Inc. for \$1.8 billion and General American Oil Company for \$1.2 billion. These expenditures, except for the purchase of company stock and Aminoil Inc., were funded primarily by funds from continuing operations totaling \$6.4 billion. Other funds were provided by property sales and retirements of \$927 million, of which the majority was due to the asset sales program in 1985. Investment sales totaled \$245 million; issuance of company stock totaled \$431 million, including preferred stock; other sources provided \$229 million; and a decrease in working capital provided \$175 million. Discontinued operations required funds totaling a net of \$76 million over the last three years.

Long-term debt of \$7.0 billion was issued during the last three years, the majority of which resulted from the 1985 exchange of debt securities aggregating \$4.5 billion for approximately half of the company's outstanding common stock.

Capital Expenditures

Phillips worldwide operations are capital intensive, requiring significant expenditures over long construction periods. Capital expenditures for properties, plants and equipment totaled \$1.1 billion in 1985, compared with \$1.4 billion in 1984 and \$1.1 billion in 1983. Over the past three years, significant expenditures have been made for developing the Maureen field in the U.K. North Sea and the waterflood project in the Norwegian North Sea; for developing existing domestic properties and connecting new gas to existing facilities; and for modernizing and improving the feedstock flexibility of Phillips major refineries. During this period, almost 80 percent of the company's capital expenditures were made in the United States. Over the three-year period, capital expenditures for Petroleum Exploration and Production operations accounted for 60 percent of the total; Gas and Gas Liquids operations — 17 percent; Petroleum Refining, Marketing and Transportation operations — 9 percent; Chemicals operations — 5 percent; and Corporate and Other — 9 percent.

Phillips expects that capital expenditures for 1986 will be approximately \$1.0 billion or about the same level as last year. However, due to uncertainties in oil and gas prices, capital expenditures for 1986 will be continually reviewed. The major portion of capital expenditures will be devoted to projects for Exploration and Production, primarily the development of offshore California and Gulf of Mexico properties and the Ekofisk field waterflood program. Over three-fourths of these expenditures are projected to be for development of existing properties. Expenditures for Gas and Gas Liquids will be devoted primarily to connecting gas to existing plants in active drilling areas and maintaining processing plants. Other capital expenditure projects include modifying refineries to meet the new EPA lead phase-down rule and expanding polypropylene plastic resin facilities at the Houston, Texas, chemical complex.

Funds Availability

The company engaged in both short-term and long-term financing during the year. The company issued commercial paper and sold receivables to Phillips Petroleum Credit Corporation (Credit), a wholly owned nonconsolidated subsidiary. At year-end, Credit held \$121 million of Phillips receivables. Short-term debt outstanding at year-end was \$30 million for the company and none for Credit, compared with \$1.9

billion and \$270 million, respectively, at year-end 1984. The decrease in short-term debt was due essentially to the retirement of commercial paper and the retirement of the current portion (\$750 million) of the \$1.25 billion Revolving Credit Agreement. The net increase in long-term debt was \$3.7 billion. This resulted primarily from an exchange of company debt securities equivalent to \$62 per share face value (totaling \$4.5 billion) for 72.58 million shares of the company's common stock under the exchange offer dated March 4, 1985, and a \$1 billion drawdown under the \$1 billion Revolving Credit Facility, offset by debt retirements. The exchange offer debt securities consisted of \$2.1 billion in Floating Rate Senior Notes due 1995 bearing an interest rate of 9 $\frac{1}{16}$ percent at December 31, 1985, \$1.3 billion of 13 $\frac{7}{8}$ % Senior Notes due 1997, and \$1.1 billion of 14 $\frac{3}{4}$ % Subordinated Debentures due 2000. The major debt retirements included the entire \$1 billion Revolving Credit Facility and the \$500 million long-term portion of the \$1.25 billion Revolving Credit Agreement.

In April 1985, the company entered into the \$1 billion Revolving Credit Facility with a group of international banks and subsequently drew down the entire \$1 billion. At December 31, 1985, the company had repaid the entire Facility and had given notice for cancellation of \$700 million of the Facility effective in

January 1986. The company also prepaid and canceled in full its \$1.25 billion Revolving Credit Agreement.

The \$1 billion Revolving Credit Facility places limitations on additional debt and other restrictions. The indentures associated with the exchange offer also have certain restrictions.

The company has previously announced that it will sell approximately \$2 billion of assets to reduce debt. Through the end of 1985, \$1.1 billion had been sold.

Increased debt and attendant interest expense, credit ratings, and the decline and uncertainty in oil and gas prices materially affect the company's access to financial markets. To meet its liquidity requirements, the company will look primarily to funds from operations and sales of assets.

As a result of recent declines in worldwide oil and gas prices, reported financial information may not be indicative of the company's future operating results or of the future financial condition of the company. The impact of these declines on the future operating results and the future financial condition of the company cannot at this time be predicted.

Results of Operations

Consolidated net income of \$418 million for 1985 includes losses and write-downs from the company's

Summary of Income

Years Ended December 31

	Millions of Dollars					
	Income Before Income Taxes			Net Income		
	1985	1984	1983	1985	1984	1983
Petroleum Exploration and Production						
United States	\$ 539	549	530	297	323	288
Outside United States	1,260	1,170	1,317	147	172	149
	1,799	1,719	1,847	444	495	437
Gas and Gas Liquids	267	321	495	152	178	276
Petroleum Refining, Marketing and Transportation						
United States	272	120	105	157	83	76
Outside United States	13	21	29	13	14	18
	285	141	134	170	97	94
Worldwide Petroleum	2,351	2,181	2,476	766	770	807
Worldwide Chemicals	193	191	61	128	128	45
Corporate and Other	(591)	(254)	(187)	(298)	(61)	(92)
Continuing Operations	1,953	2,118	2,350	596	837	760
Discontinued Operations	(322)	(53)	(73)	(178)	(27)	(39)
	\$1,631	2,065	2,277	418	810	721

discontinued minerals operations of \$178 million. Income from continuing operations in 1985 of \$596 million was down 29 percent from 1984 and down 22 percent from 1983.

The primary factors behind the decline in income from continuing operations were the write-down of the company's other assets being held for sale, mainly gas plants and chemical assets; higher interest expense and foreign currency transaction losses; and lower sales prices for crude oil, natural gas liquids and petroleum products. These negative factors were partly offset by gains on sales under the asset disposition program; the adoption of a new pension accounting standard; lower raw material costs and improved operating efficiencies in petroleum refining and marketing operations; and higher U.S. crude oil and natural gas liquids production.

Average 1985 sales prices and their percentage fluctuations from 1984 follow: U.S. crude oil, \$24.56 per barrel, down 6 percent; average foreign crude oil, \$26.88 per barrel, down 7 percent; U.S. natural gas, \$2.23 per thousand cubic feet, down 3 percent; average foreign natural gas, \$3.71 per thousand cubic feet, up 4 percent; U.S. natural gas liquids, \$13.13 per barrel, down 11 percent; automotive gasoline, unchanged at \$.82 per gallon; and distillates, \$.78 per gallon, down 5 percent.

Petroleum Exploration and Production

Earnings for 1985 were \$444 million, compared with \$495 million in 1984 and \$437 million in 1983.

Domestic earnings in 1985 were \$297 million, compared with \$323 million in 1984 and \$288 million in 1983. The 8-percent decrease in 1985 was caused primarily by lower crude oil sales prices, higher production costs and higher depreciation and depletion expenses. These negative factors were partly offset by increased production for both crude oil and natural gas and lower exploration expenses. Earnings in 1984 included a reversal of a contingency reserve following final resolution of legal proceedings in a natural gas pricing dispute, which increased last year's net income.

Net income outside the United States was \$147 million in 1985, compared with \$172 million in 1984 and \$149 million in 1983. Earnings in 1985 decreased \$25 million due principally to foreign currency transaction losses, compared with gains in 1984, lower Norway crude oil production and sales prices, and lower U.K. crude oil sales prices. Earnings for

1984 were also adversely affected by the recognition in 1984 of prior years' income taxes related to U.K. operations.

Gas and Gas Liquids

Earnings for 1985 were \$152 million, compared with \$178 million in 1984 and \$276 million in 1983. The \$26 million decrease in 1985 was due primarily to lower natural gas liquids and residue gas sales prices, partly offset by higher natural gas sales volumes and higher natural gas liquids production.

Petroleum Refining, Marketing and Transportation

Earnings for 1985 rose to \$170 million, compared with \$97 million in 1984 and \$94 million in 1983. Earnings improved \$73 million due primarily to improved operating efficiencies and lower operating expenses, mainly feedstock costs. These improvements were partly offset by lower sales prices for liquefied petroleum gas, distillates and aviation fuels.

Chemicals

Earnings for 1985 were the same as those for 1984 — \$128 million, while 1983 earnings were \$45 million. Earnings in 1985 benefited from lower operating costs and higher foreign earnings, but were offset by lower sales prices, primarily for olefins and plastic resins.

Corporate and Other

Corporate and Other consists primarily of interest expense, interest income and the results of other corporate activities, including in 1985 gains and losses associated with the company's asset disposition program reported as unusual items. Corporate and Other reflected a loss of \$298 million in 1985, compared with losses of \$61 million and \$92 million in 1984 and 1983, respectively.

The increase in the loss for 1985 of \$237 million was due to higher interest expense, mainly as a result of debt securities issued in connection with the exchange offer and the purchase of Aminoil in October 1984; a write-down of assets held for sale, primarily gas plants and chemical assets; and the recognition in 1984 of the tax benefit from U.K. net operating losses related to prior years' interest expense. These negative factors were partly offset by net gains from the sale of assets.

Discontinued Operations

The company discontinued its minerals operations and wrote the assets down to their estimated net realizable value in the fourth quarter of 1985. For additional information, see Note 1 of Notes to Financial Statements.

Exploratory Costs and Leasehold Impairment

Over the past three years, Phillips has charged against income a total of \$1.7 billion of costs relating to its worldwide exploration for petroleum reserves. Certain exploratory costs are expensed as incurred while others are capitalized or expensed, depending upon the success or failure of the particular venture. A comparison of the components of exploratory costs and leasehold impairment for the last three years is shown below.

	Millions of Dollars		
	1985	1984*	1983*
Geological and geophysical expenses	\$208	269	241
Impairment of leasehold investments	142	182	182
Dry hole costs	83	109	214
Lease rentals	16	13	13
	\$449	573	650

*Restated for discontinued operations.

Provision for Income Taxes

The provision for income taxes for continuing operations increased \$76 million in 1985; the 1984 total provision decreased \$309 million from 1983. Higher foreign currency transaction losses on income tax liabilities were the primary reason for the higher income tax provision in 1985. The effective income tax rate, including discontinued operations, was 74 percent in 1985, compared with 61 percent in 1984 and 68 percent in 1983. The increase in the effective income tax rate in 1985 was due mainly to a higher percentage of income before tax from Norway to total income before tax in 1985 as compared with 1984. The Norway percentage increase was due primarily to lower domestic income before tax in 1985 which was due primarily to higher interest expense. Transaction losses in 1985 on Norway and U.K. income tax liabilities also increased the effective income tax rate. In addition to income taxes, operating taxes accrued

by the company include the federal excise tax on U.S. crude oil which, since its inception in 1980, has totaled \$1.2 billion, including \$127 million in 1985.

Foreign Currency Translation

The principal functional currency used to measure the company's foreign oil and gas operations is the U.S. dollar. Chemicals operations in foreign countries use the local currency. The company's major foreign currency exposure is the Norwegian krone. This exposure is managed by purchasing forward exchange contracts or by holding krone-denominated cash investments.

Changing Prices and the Effect of Inflation

Supplementary information concerning the impact of inflation is provided on pages 50 and 51.

Common Stock Prices and Cash Dividends Per Share

Quarter	1985		
	Stock Price		Dividends
	High	Low	
First*	\$17 $\frac{1}{8}$	12 $\frac{1}{4}$	.20
Second*	13 $\frac{7}{12}$	11 $\frac{1}{4}$	.25
Third	13 $\frac{1}{4}$	11 $\frac{1}{4}$	.25
Fourth	13 $\frac{1}{2}$	11	.25

Quarter	1984*		
	Stock Price		Dividends
	High	Low	
First	\$15 $\frac{1}{12}$	11 $\frac{1}{8}$	.18
Second	14 $\frac{13}{24}$	11 $\frac{5}{12}$	.20
Third	14 $\frac{1}{24}$	11 $\frac{1}{8}$	.20
Fourth	18 $\frac{3}{4}$	12 $\frac{1}{4}$	.20

Closing Stock Price at December 31, 1985 **\$12 $\frac{1}{8}$**

Number of Stockholders of Record at January 31, 1986 **84,830**

*Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

Phillips common stock is traded on the New York, Pacific and Toronto stock exchanges.

Selected Financial Data

	Millions of Dollars Except Per Share Amounts				
	1985	1984*	1983*	1982*	1981*
Sales and other operating revenues	\$15,636	15,527	15,248	15,697	15,965
Income from continuing operations	596	837	760	701	940
Income from continuing operations per common share**	2.07	1.81	1.65	1.53	2.06
Total assets	14,045	16,955	13,088	12,073	11,252
Long-term debt	6,547	2,839	2,242	1,955	1,100
Redeemable preferred stock	281	—	—	—	—
Cash dividends declared per common share**	.95	.78	.73	.73	.73

*Restated for discontinued operations.

**Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

See Management's Discussion and Analysis on pages 26 through 29 for discussion of factors that would enhance an understanding of these financial data and that might cause these data not to be indicative of Phillips future financial condition or results of operations.

Report of Certified Public Accountants

The Board of Directors and Stockholders
Phillips Petroleum Company

We have examined the accompanying consolidated balance sheet of Phillips Petroleum Company at December 31, 1985 and 1984, and the related consolidated statements of income and earnings employed in the business and changes in financial position for each of the three years in the period ended December 31, 1985. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statements mentioned above present fairly the consolidated financial position of Phillips Petroleum Company at December 31, 1985 and 1984, and the consolidated results of operations and changes in financial position for each of the three years in the period ended December 31, 1985, in conformity with generally accepted accounting principles applied on a consistent basis during the period.

Arthur Young & Company

Tulsa, Oklahoma
February 13, 1986

Consolidated Statement of Income and Earnings Employed in the Business

PHILLIPS PETROLEUM COMPANY

Years Ended December 31

Millions of Dollars

	1985	1984*	1983*
Revenues			
Sales and other operating revenues	\$15,636	15,527	15,248
Equity in earnings of affiliated companies	37	42	46
Other revenues	127	177	115
Total Revenues	15,800	15,746	15,409
Costs and Expenses			
Purchased crude oil and products	9,041	9,057	8,857
Production and operating expenses	1,829	1,898	1,850
Exploratory costs and leasehold impairment	449	573	650
Selling, general and administrative expenses	412	476	435
Depreciation, depletion, amortization and retirements	1,044	905	573
Taxes other than income taxes	406	405	447
Interest and expense on indebtedness	846	314	247
Total Costs and Expenses	14,027	13,628	13,059
Income from continuing operations before unusual items and income taxes	1,773	2,118	2,350
Unusual items	180	—	—
Income from continuing operations before income taxes	1,953	2,118	2,350
Provision for income taxes	1,357	1,281	1,590
Income from Continuing Operations	596	837	760
Discontinued operations (net of income taxes)			
Loss from operations	(7)	(27)	(39)
Loss on disposal	(171)	—	—
Net Income	418	810	721
Earnings Employed in the Business			
Beginning of Year	6,057	5,609	5,225
Cash dividends declared and paid			
Common	(261)	(362)	(337)
Preferred	(12)	—	—
Common stock dividend	(2,996)	—	—
Treasury stock sold to employee benefit plans	(416)	—	—
Preferred stock dividend	(281)	—	—
Accretion of discount on preferred stock	(2)	—	—
End of Year	\$ 2,507	6,057	5,609
Income Per Share of Common Stock**			
Continuing operations	\$ 2.07	1.81	1.65
Net income	1.44	1.75	1.57
Average Shares Outstanding (in thousands)**	278,916	462,247	459,572

*Restated for discontinued operations.

**Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

See accounting policies and notes to financial statements.

Consolidated Balance Sheet

PHILLIPS PETROLEUM COMPANY

At December 31

Millions of Dollars

	1985	1984*
Assets		
Current Assets		
Cash and Short-Term Investments	\$ 676	1,894
Accounts and Notes Receivable (less allowances: 1985 — \$16; 1984 — \$23)	1,645	1,678
Inventories	642	871
Prepaid Expenses and Other Current Assets	181	159
Total Current Assets	3,144	4,602
Investments and Long-Term Receivables	375	447
Properties, Plants and Equipment (net)	10,281	11,188
Deferred Charges	83	53
Net Assets of Discontinued Operations	162	665
Total	\$14,045	16,955
Liabilities		
Current Liabilities		
Accounts Payable	\$ 1,331	1,676
Notes Payable	30	1,890
Long-Term Debt due within one year	207	82
Accrued Income and Other Taxes	1,261	1,494
Other Accruals	281	203
Total Current Liabilities	3,110	5,345
Long-Term Debt	6,547	2,839
Other Long-Term Liabilities	533	443
Accrued Contingent Liabilities	151	119
Deferred Income Taxes	1,673	1,433
Other Deferred Credits	70	115
Minority Interest in Consolidated Subsidiaries	36	37
Total Liabilities	12,120	10,331
Redeemable Preferred Stock		
Series A Adjustable Rate (\$1.00 par value)		
Shares Issued and Outstanding (1985 — 11,961,199; 1984 — 0)		
(mandatory redemption value — \$299)	281	—
Common Stockholders' Equity		
Common Stock — 500,000,000 shares authorized at \$1.25 par value		
Issued (1985 — 248,684,301 shares; 1984 — 154,951,981 shares)		
Par Value	311	194
Capital in Excess of Par	213	499
Treasury Stock (at cost: 1985 — 21,543,631 shares; 1984 — 325,275 shares)	(1,313)	(16)
Foreign Currency Translation Adjustments	(74)	(110)
Earnings Employed in the Business	2,507	6,057
Total Common Stockholders' Equity	1,644	6,624
Total	\$14,045	16,955

*Restated for discontinued operations.

See accounting policies and notes to financial statements.

Consolidated Statement of Changes in Financial Position

PHILLIPS PETROLEUM COMPANY

Years Ended December 31

Millions of Dollars

	1985	1984*	1983*
Funds Provided from Continuing Operations Consisted of			
Income from continuing operations	\$ 596	837	760
Noncash items included in earnings			
Depreciation, depletion, amortization and retirements	1,044	905	573
Dry hole costs and leasehold impairment	225	291	396
Other	264	200	287
	2,129	2,233	2,016
While Funds Were Expended for			
Capital expenditures (including dry hole costs)	1,060	1,368	1,128
Purchase of net noncurrent assets of acquired companies	—	1,784	1,229
Investments	—	13	23
Reduction of long-term debt	1,864	406	95
Dividends to company stockholders	554	362	337
Purchase of company stock	4,972	—	—
Other	26	59	19
	8,476	3,992	2,831
Which Left a Deficiency of	6,347	1,759	815
Additional Funds Were Provided from			
Long-term debt	5,576	1,032	382
Property sales and retirements	800	56	71
Sale of investments	7	41	197
Issuance of company stock	372	55	4
Other	167	47	15
	6,922	1,231	669
Discontinued Operations	202	(233)	(45)
Which Resulted in Increased (Decreased) Working Capital of	\$ 777	(761)	(191)
Working Capital Changes			
Increase (Decrease) in Current Assets			
Cash and short-term investments	\$(1,218)	988	113
Accounts and notes receivable	(33)	462	(10)
Inventories	(229)	206	(90)
Prepaid expenses and other current assets	22	51	(18)
(Increase) Decrease in Current Liabilities			
Accounts payable	345	(391)	(51)
Notes payable	1,860	(1,779)	41
Long-term debt due within one year	(125)	(52)	11
Taxes and other accruals	155	(246)	(187)
Increase (Decrease) in Working Capital	\$ 777	(761)	(191)

*Restated for discontinued operations.

See accounting policies and notes to financial statements.

Consolidation Principles and Investments — The consolidated financial statements include the accounts of companies owned more than 50 percent except for an insurance company and a credit company. Investments in these two companies, in companies owned 20–50 percent, inclusively, and in corporate joint ventures are accounted for using the equity method of accounting (affiliated companies). Investments in other companies are carried at cost.

Inventories — Crude oil, petroleum products, chemicals and merchandise are valued at cost, which is lower than market in the aggregate, mainly on the last-in, first-out (LIFO) basis. Materials and supplies are valued at or below average cost.

Oil and Gas Exploration and Development — Oil and gas exploration and development costs are accounted for using the successful efforts method of accounting.

Property Acquisition Costs — Oil and gas leasehold acquisition costs are capitalized. Leasehold impairment is recognized based upon unsuccessful exploratory experience. Upon discovery of commercial reserves, leasehold costs are transferred to producing properties.

Exploratory Costs — Geological and geophysical expenses and the costs of carrying and retaining undeveloped properties are charged against income as incurred. Exploratory drilling costs are capitalized when incurred. If exploratory wells are determined to be commercially unsuccessful (dry holes), applicable costs are expensed.

Development Costs — Costs incurred to drill and equip development wells, including unsuccessful development wells, are capitalized.

Depletion and Amortization — Leasehold costs of producing properties are depleted using the unit-of-production method based on estimated proved recoverable oil and gas reserves. Amortization of intangible development costs is based on the unit-of-production method using the estimated proved developed recoverable oil and gas reserves.

Depreciation and Amortization — Depreciation and amortization of properties, plants and equipment, including assets under capital leases, are determined by the group straight-line method, individual unit straight-line method or the unit-of-production method, applying the method considered most appropriate for each type of property.

Property Dispositions — When complete units of depreciable property are retired or sold, the asset cost and related accumulated depreciation are eliminated with any gain or loss reflected in income. When less than complete units of depreciable property are disposed of or retired, the difference between asset cost and salvage value is charged or credited to accumulated depreciation.

Dismantlement, Removal and Restoration Costs — The estimated costs, net of salvage values, of dismantling and removing major facilities, including necessary site restoration, are accrued currently. Accrual methods used are unit-of-production and straight-line, applying the method considered most appropriate for each type of property.

Foreign Currency Translation — The U.S. dollar is the functional currency for most of the company's operations. Adjustments resulting from the process of translating foreign functional currency financial statements into U.S. dollars are taken directly to a separate component of common stockholders' equity. Foreign currency transaction gains and losses are included in income.

Income Taxes — Deferred taxes are provided for all significant timing differences in the recognition of revenues and expenses for tax and financial purposes. Allowable tax credits are applied currently as reductions of the provision for income taxes. No provision for U.S. income taxes is made on undistributed earnings of certain companies and corporate joint ventures because of reinvestment plans for such funds.

Income Per Share of Common Stock — Income per share of common stock is determined after deducting the dividend requirements of preferred stock and the accretion of the excess of redemption value of preferred stock over its carrying value. The calculation is based upon the daily weighted average number of common shares outstanding during the period.

Notes to Financial Statements

PHILLIPS PETROLEUM COMPANY

Note 1 – Discontinued Operations and Unusual Items

During the fourth quarter of 1985, the company announced plans to discontinue its minerals operations. Assets associated with these operations have been sold, abandoned, or written down to estimated net realizable value in anticipation of their future sale or abandonment, resulting in an estimated net loss on disposal of \$171 million, net of income tax benefits of \$132 million. The estimated net loss on disposal includes \$21 million for estimated operating losses during the phase-out period. Additional information relating to discontinued operations for the years ended December 31 follows:

	Millions of Dollars		
	1985	1984	1983
Sales and other operating revenues	\$ 40	10	1
Loss before income tax benefits	\$(19)	(53)	(73)
Provision for income tax benefits	12	26	34
Loss from operations	\$ (7)	(27)	(39)

Net assets of discontinued operations at December 31 consisted of the following:

	Millions of Dollars	
	1985	1984
Current assets	\$ 6	9
Current liabilities	(4)	(7)
	2	2
Properties, plants and equipment (net)	84	585
Other noncurrent assets	79	81
Noncurrent liabilities	(3)	(3)
	\$162	665

Unusual items consisted of the following for the year ended December 31, 1985:

	Millions of Dollars
Special early retirement programs	\$ (21)
Sale of assets	496
Write-down of assets held for disposition	(295)
	\$ 180

On May 14 and August 2, 1985, the company announced special early retirement programs. Under FASB Statement No. 88, "Employers' Accounting for

Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits," which the company adopted effective January 1, 1985, a liability and a one-time expense of \$21 million were recognized for the net cost of the programs. As a result, net income decreased \$11 million (\$.04 per common share). If the new standard had not been adopted, the net cost of the programs would have been \$115 million and net income would have been \$50 million less (\$.18 per common share).

In conjunction with the exchange offer dated March 4, 1985, the company announced its intent to realize \$2 billion through the sale of selected assets. Through December 31, 1985, the company had realized \$1.1 billion through asset sales which included \$219 million for mineral assets. The remaining asset sales consisted primarily of oil and gas properties. The company also provided for the write-down of certain gas plants and chemical assets to estimated net realizable value in contemplation of their future sale. Net gains on asset sales less write-downs (excluding those of discontinued operations) increased net income \$147 million (\$.53 per common share).

The Notes to Financial Statements have been restated where applicable to exclude discontinued operations.

Note 2 – Inventories

Inventories at December 31 consisted of the following:

	Millions of Dollars	
	1985	1984
Crude oil, petroleum products and chemicals	\$472	640
Merchandise	22	22
	494	662
Materials and supplies	148	209
	\$642	871

Inventories valued on a LIFO basis totaled \$393 million and \$555 million at December 31, 1985 and 1984, respectively, and would have been approximately \$665 million and \$745 million higher, respectively, had they been valued using the first-in, first-out (FIFO) method. The FIFO values were determined using costs and allocations consistent with those used to determine LIFO inventories.

The reduction of certain LIFO inventory quantities in 1985, 1984 and 1983 increased net income \$1 million, \$8 million and \$45 million, respectively.

Note 3 – Investments and Long-Term Receivables

Components of investments and long-term receivables at December 31 were as follows:

	Millions of Dollars	
	1985	1984
Investments in and advances to affiliated companies:		
Phillips Petroleum Credit Corporation	\$119	118
Walton Insurance Limited	15	16
Companies owned 50 percent or less	161	217
Long-term receivables	61	80
Other investments	19	16
	\$375	447

Earnings employed in the business at December 31, 1985, included \$159 million relating to undistributed earnings of affiliated companies. Dividends received from affiliated companies were \$41 million, \$41 million and \$31 million in 1985, 1984 and 1983, respectively.

Phillips Petroleum Credit Corporation (Credit) purchases certain accounts receivable from Phillips with funds obtained from short-term borrowings. During 1985, 1984 and 1983, Phillips received \$1.8 billion, \$4.7 billion and \$5.3 billion, respectively, in proceeds from the sale of accounts receivable to Credit. At December 31, 1985, Credit held accounts receivable acquired from Phillips of \$121 million. Credit held no Phillips receivables at December 31, 1984.

Walton Insurance Limited (Walton) participated in the international reinsurance business, including insuring certain Phillips risks, until January 27, 1983, when Walton ceased writing new third-party reinsurance.

Summarized information relating to results of operations and to assets and liabilities for Credit, Walton and companies owned 50 percent or less follows:

	Millions of Dollars		
	1985	1984	1983
Credit			
Revenues	\$ 12	44	35
Costs and expenses	9	33	28
Income before income taxes	3	11	7
Net income	1	6	4
Current assets	120	390	451
Current liabilities	1	272	329

	Millions of Dollars		
	1985	1984	1983
Walton			
Underwriting income			
International reinsurance	\$ 27	71	127
Phillips	27	26	24
Underwriting expense	76	129	173
Net underwriting loss	(22)	(32)	(22)
Investment income	21	23	19
Net loss	(1)	(9)	(3)
Cash, time deposits and marketable debt securities	109	96	122
Other assets	97	111	129
Provision for losses	104	99	140
Other liabilities	32	37	31

Companies Owned 50 Percent or Less

Revenues	\$2,730	2,642	3,234
Cost and expenses	2,289	2,268	2,843
Income before income taxes	441	374	391
Net income	272	215	236
Current assets	728	681	688
Other assets	2,103	2,107	2,680
Current liabilities	659	486	601
Other liabilities	1,671	1,909	2,363

Note 4 – Properties, Plants and Equipment

The company's investment in properties, plants and equipment (at cost) at December 31 is summarized as follows:

	Millions of Dollars	
	1985	1984
Exploration and Production	\$ 9,395	9,557
Gas and Gas Liquids	2,093	1,971
Petroleum Products	2,870	2,762
Chemicals	1,533	1,503
Corporate and Other	798	856
	16,689	16,649
Accumulated depreciation, depletion and amortization	6,408	5,461
	\$10,281	11,188

Assets under capital leases included above	\$ 34	36
Accumulated amortization	23	23
	\$ 11	13

Note 5 – Exchange Offer

On March 28, 1985, under an exchange offer dated March 4, 1985, the company exchanged a package of debt securities aggregating \$4.5 billion for 72.58 million shares of its common stock. The debt securities exchanged consisted of: \$2.1 billion aggregate principal amount of Floating Rate Senior Notes due 1995; \$1.3 billion aggregate principal amount of 13% Senior Notes

due 1997; and \$1.1 billion aggregate principal amount of 14¾% Subordinated Debentures due 2000. Additionally, on May 29, 1985, company stockholders approved an increase in the number of authorized common shares from 200 million to 500 million and authorized 300 million shares of preferred stock, the terms of which may be set by the Board of Directors. Effective May 31, 1985, the company effected a three-for-one stock split in the form of a 200-percent common stock dividend and issued a special dividend distribution of approximately 12 million shares of \$1.00 par value Series A Adjustable Rate Preferred Stock.

Note 6 – Debt

Short-Term

Short-term borrowings at December 31 consisted of the following:

	Millions of Dollars	
	1985	1984
Notes payable	\$15	768
Commercial paper	15	1,122
	\$30	1,890
Weighted average interest rate	8%	10

Long-Term

Long-term debt due after one year at December 31 consisted of the following:

	Millions of Dollars	
	1985	1984
Floating Rate Senior Notes Due 1995*	\$1,973	—
14¾% Subordinated Debentures Due 2000	1,089	—
14% Guaranteed Notes Due 1989	200	200
13⅞% Senior Notes Due 1997	1,306	—
12⅞% Notes Due September 1, 1992	200	200
12¼% Debentures Due 2012	300	300
11¼% Debentures Due 2013	250	250
8⅞% Debentures Due 2000	175	191
7⅞% Debentures Due 2001	109	112
5⅞% Marine Terminal Revenue Bonds, Series 1977 Due 2007	20	20
Notes payable to banks, insurance companies and others due through 1993		
At 11%–15½%	179	712
At 8⅞%–10⅞%	169	364
At 4⅞%–8⅞%	183	30
Production payment	376	437
Obligations under capital leases	12	16
Purchase obligations	6	7
	\$6,547	2,839

*Interest rate at December 31, 1985, was 9⅞ percent.

Maturities of long-term debt in the years 1986 through 1990 are: \$207 million (included in current liabilities), \$181 million, \$178 million, \$311 million and \$88 million, respectively.

On December 21, 1984, the company sold a \$500 million production payment (the Production Payment). The Production Payment consists of an undivided dedicated percentage of net subject hydrocarbons (e.g., oil, gas and gas liquids) produced from certain leases and producing units, in which the company has interests, in and offshore Alaska, in West Texas and offshore Louisiana. The Production Payment bears a floating rate of interest, which was 8⅞ percent at December 31, 1985. The company may repurchase the Production Payment only in its entirety on or before December 31, 1986, upon payment of a premium of ⅞ of 1 percent of the then outstanding amount of the primary balance (as defined in the Production Payment conveyance). Thereafter, all or a portion of the Production Payment may be repurchased without penalty in minimum increments of \$50 million. The Production Payment is payable solely from the production and sale of the conveyed hydrocarbons.

Lines of Credit

During 1985 the company and Credit arranged a \$1 billion Revolving Credit Facility with a group of international banks. The Facility bears interest at a rate of ⅞ of 1 percent above rates offered by certain designated banks in the London Interbank Market and calls for a commitment fee of ⅜ of 1 percent per annum on any unused commitments. The company canceled \$700 million of this Facility effective in January 1986. The balance of the Facility will expire in April 1988. The Facility contains restrictions on total indebtedness and other financial restrictions. At December 31, 1985, no balance was outstanding.

The company and Credit also have committed lines of credit of \$152 million available through mid-1986.

Compensating Balances

The company maintains compensating balances for substantially all of the \$152 million committed lines of credit. The company also maintains compensating balances for banking services under various arrangements with several banks. The compensating balances are not legally restricted as to withdrawal and are continually reviewed and adjusted based on levels of services and activity. The total of all compensating balances is not material in relation to total liquid assets.

Note 7 — Other Long-Term Liabilities

Other long-term liabilities consist mainly of accrued liabilities for dismantling offshore exploration and production facilities.

Note 8 — Non-Mineral Leases

The company leases bulk and service stations, computers and other facilities and equipment under both capital and operating leases.

At December 31, 1985, future minimum payments due under noncancelable leases were as follows:

	Millions of Dollars	
	Capital Leases	Operating Leases
1986	\$ 6	43
1987	4	34
1988	3	24
1989	3	20
1990	3	16
Remaining years	7	213
Total payments*	26	350
Less imputed interest	10	
Present value	16	
Amount included in current liabilities	4	
Obligations under capital leases	\$12	

*Minimum payments have not been reduced by aggregate minimum sublease rentals due under noncancelable subleases of \$2 million for capital leases and \$1 million for operating leases.

Operating lease rental expense for the years ended December 31 was as follows:

	Millions of Dollars		
	1985	1984	1983
Total rentals	\$110	92	79
Less sublease rentals	9	8	8
Net rentals	\$101	84	71

Note 9 — Redeemable Preferred Stock

Each Series A preferred share has a liquidation value of \$25 and is redeemable at the option of the company at prices declining \$.25 per share annually from \$25.75 per share prior to May 15, 1986, until the mandatory redemption value of \$25 per share is reached, with required redemption on May 15, 1990. The dividend rate is adjusted quarterly based on certain applicable U.S. Treasury rates. The dividend rate was 9 percent at December 31, 1985. The preferred stockholders do not have voting rights, unless dividends payable become six quarters in arrears, at which time the holders of the preferred, voting as a class, shall have the right to elect two directors. No dividends may be paid on common stock unless full cumulative dividends on the preferred stock have been declared and paid.

The preferred stock was recorded at fair market value at issuance. The excess of the redemption value over the carrying value is being accreted over the life of the issue.

Note 10 — Common Stockholders' Equity

Changes in common stock, treasury stock and foreign currency translation adjustments follow:

	Common Stock		
	Shares Issued	Shares Held in Treasury	Shares Outstanding
December 31, 1982	154,449,429	1,329,961	153,119,468
Issued under Incentive Compensation Plans		(103,696)	103,696
December 31, 1983	154,449,429	1,226,265	153,223,164
Issued in exchange for debt	502,552	(900,000)	1,402,552
Issued under Incentive Compensation Plans		(990)	990
December 31, 1984	154,951,981	325,275	154,626,706
Issued under Incentive Compensation Plans		(20,344)	20,344
Stock purchases		8,898,800	(8,898,800)
Exchange offer		72,580,000	(72,580,000)
Sold to employee benefit plans		(7,240,100)	7,240,100
Common stock dividend	93,732,320	(53,000,000)	146,732,320
December 31, 1985	248,684,301	21,543,631	227,140,670

	Millions of Dollars			
	Common Stock Par Value	Capital in Excess of Par	Treasury Stock	Foreign Currency Translation Adjustments
December 31, 1982	\$193	492	(68)	(69)
Current period translation adjustments				(30)
Translation adjustments recognized in anticipation of disposal of foreign investments				18
Issued under Incentive Compensation Plans		(2)	6	
December 31, 1983	193	490	(62)	(81)
Current period translation adjustments				(29)
Issued in exchange for debt	1	9	46	
December 31, 1984	194	499	(16)	(110)
Current period translation adjustments				51
Translation adjustments recognized upon disposal of foreign investments				(15)
Issued under Incentive Compensation Plans			1	
Stock purchases			(472)	
Exchange offer			(4,500)	
Sold to employee benefit plans		67	442	
Common stock dividend	117	(353)	3,232	
December 31, 1985	\$311	213	(1,313)	(74)

Note 11 – Note Purchase Rights

Note Purchase Rights were distributed to holders of the company's common stock on February 18, 1985, with one Right being distributed for each share of common stock. Such Rights become exercisable only if a person or group acquires 30 percent or more of the company's outstanding common stock. After adjustment to reflect the common stock split and preferred stock dividend, a Note Purchase Right, when exercisable, entitles the holder to exchange one share of the company's common stock for \$19.31 principal amount of one-year 15% Senior Notes, subject to adjustment in certain specified events. Note Purchase Rights held by the person or group acquiring 30 percent or more of the company's common stock become null and void upon such acquisition. The adjusted redemption price is 8½ cents per Right. The Note Purchase Rights will expire on February 28, 1995, unless previously exercised or redeemed. At December 31, 1985, there were 227 million outstanding Rights.

Note 12 – Litigation and Contingent Liabilities

A number of legal proceedings are pending in various courts or agencies in which the company or a subsidiary appears as plaintiff or defendant. On January 13, 1986,

the U.S. District Court at Los Angeles, California, preliminarily approved the company's settlements of the civil class action suits filed by the states of California, Arizona, Oregon and Washington. These cases were filed against numerous petroleum companies, alleging extensive violations of the antitrust laws relating to the production and refining of crude oil, and the transportation and marketing of crude oil and refined products.

At December 31, 1985 and 1984, the company was contingently liable for \$21 million and \$25 million, respectively, for obligations of affiliated companies and others. In addition, the company had contingent liabilities at both dates resulting from throughput agreements with pipeline and processing companies in which it holds stock interests. Under these agreements, Phillips may be required to provide any such company with additional funds through advances against future charges for the shipping or processing of petroleum liquids, natural gas and refined products.

While it is not possible at this time to establish the ultimate amount of liability with respect to contingent liabilities, including those related to legal proceedings, the company is of the opinion that the aggregate amount of any such liabilities for which provision has not been made will not have a material adverse effect on its financial position.

Note 13 – Taxes

Taxes charged to income were as follows:

	Millions of Dollars		
	1985	1984	1983
Taxes Other Than Income Taxes			
Property	\$ 76	64	65
Crude oil excise	127	137	186
Production	115	124	119
Payroll	55	52	50
Other	33	28	27
	406	405	447
Discontinued operations	6	1	—
	412	406	447
Income Taxes			
Federal			
Current	(8)	57	145
Deferred	193	192	176
Foreign			
Current	964	987	1,094
Deferred	189	28	161
State and local (current)	19	17	14
	1,357	1,281	1,590
Discontinued operations	(144)	(26)	(34)
	1,213	1,255	1,556
Total taxes charged to income	\$1,625	1,661	2,003

Federal income taxes of \$193 million and \$73 million were paid in 1985 and 1983, respectively, related to the purchases of Aminoil Inc. and General American Oil Company.

Deferred income taxes related to timing differences were:

	Millions of Dollars		
	1985	1984	1983
Excess of tax depreciation over financial	\$ 387	311	228
Excess of intangible drilling and certain other costs over financial provisions	114	(14)	19
Financial provision for dismantlement	(66)	(31)	121
Capitalized interest, net of amortization	20	(4)	19
Unusual items			
Special early retirement programs	(9)	—	—
Sale of assets	(24)	—	—
Write-down of assets held for disposition	(62)	—	—
Other	22	(42)	(50)
	382	220	337
Discontinued operations	(117)	4	3
	\$ 265	224	340

Deferred taxes have not been provided for the company's equity in undistributed earnings of certain companies and corporate joint ventures because of reinvestment plans for such funds. At December 31, 1985, 1984 and 1983, the aggregate of these funds was \$354 million, \$323 million and \$274 million, respectively, excluding amounts which if remitted would be expected to result in little or no tax because of available tax credits and other deductions.

The amounts of U.S. and outside U.S. income before income taxes and a reconciliation of tax at the federal statutory rate with the provision for income taxes follow:

	Millions of Dollars			Percent of Pretax Income		
	1985	1984	1983	1985	1984	1983
Continuing operations						
United States	\$ 609	817	914	37.3%	39.6	40.1
Outside						
United States	1,344	1,301	1,436	82.4	63.0	63.1
	1,953	2,118	2,350	119.7	102.6	103.2
Discontinued operations						
United States	(322)	(53)	(73)	(19.7)	(2.6)	(3.2)
	\$1,631	2,065	2,277	100.0%	100.0	100.0

	Millions of Dollars			Percent of Pretax Income		
	1985	1984	1983	1985	1984	1983
Continuing operations						
Federal statutory income tax	\$ 898	974	1,081	46.0%	46.0	46.0
Foreign taxes in excess of federal statutory rate	544	380	580	27.9	17.9	24.7
Income taxed at capital gain rate	(90)	6	(4)	(4.6)	.3	(.2)
Investment, energy, research and ESOP tax credits	(26)	(33)	(35)	(1.3)	(1.6)	(1.5)
Other	31	(46)	(32)	1.6	(2.2)	(1.4)
	\$1,357	1,281	1,590	69.6%	60.4	67.6
Discontinued operations	\$ (144)	(26)	(34)	44.7%	49.1	46.6
Total income taxes	\$1,213	1,255	1,556	74.4%	60.8	68.3

Excise taxes collected on the sale of petroleum products and paid to taxing agencies were \$166 million, \$147 million and \$144 million for the years ended December 31, 1985, 1984 and 1983, respectively.

The Internal Revenue Service has examined the company's U.S. income tax returns through 1974, and all deficiencies have been settled. The company is of the opinion that any adjustments made to the company's returns for subsequent years will not have a material effect on the financial position of the company.

Note 14 — Retirement Income Plans

The company elected to adopt FASB Statement No. 87, "Employers' Accounting for Pensions," with respect to its U.S. retirement plans, effective January 1, 1985. Application of FASB Statement No. 87 increased 1985 earnings \$31 million (\$.11 per common share).

The parent company and its subsidiaries have defined benefit plans covering substantially all employees. The parent company plan is noncontributory and benefits are based on an employee's years of service and average earnings for the three highest consecutive calendar years of compensation during the ten years immediately preceding retirement. Plans of subsidiaries are generally contributory with benefit formulas based on employee earnings. The company's funding policy for U.S. plans is to make, as a minimum contribution, the equivalent of the minimum required by the Employee Retirement Income Security Act of 1974. Plans for the majority of

foreign employees are fully insured and premiums are expensed when paid. Pension cost (income) was as follows:

	Millions of Dollars		
	1985	1984	1983
U.S. Plans			
Service cost — benefits earned during the period	\$ 28	38	27
Interest cost on projected benefit obligation	101	—	—
Actual return on assets	(300)	—	—
Net amortization and deferral	118	(37)	(2)
Net pension cost (income) for U.S. plans	(53)	1	25
Foreign Plans	8	7	8
Net pension cost (income)	\$ (45)	8	33

**Assumptions Used for U.S. Plans —
Weighted Average at December 31**

Discount rate	9¼%	8	8
Rate of increase in compensation levels	7	6	6
Long-term rate of return on assets	9¼	8	8

For 1984 and 1983, pension cost included current service cost, amortization of unfunded prior service costs and amortization of actuarial gains and losses. Amortization periods ranged from 15 to 40 years. A change in the actuarial cost method from "Entry Age" to "Projected Unit Credit," and substantial actuarial gains for the parent company plan resulting mainly from investments, reduced 1984 pension costs by \$13 million and \$20 million, respectively.

All of the company's U.S. plans have assets in excess of the accumulated benefit obligation. Plan assets include commingled funds, marketable equity securities, deposit administration insurance contracts, corporate and government debt securities, and real estate. The following table presents a reconciliation of the funded status of the plans at January 1 and December 31, 1985. Prepaid pension cost is included in deferred charges on the company's balance sheet.

	Millions of Dollars	
	December 31	January 1
Plan assets at fair value	\$1,454	1,506
Actuarial present value of benefit obligations		
Vested benefits	688	719
Nonvested benefits	39	33
Accumulated benefit obligation	727	752
Effect of projected future salary increases	219	233
Projected benefit obligation	946	985
Plan assets in excess of projected benefit obligation	508	521
Unrecognized net gain	(96)	—
Unrecognized net asset at January 1, 1985	(353)	(495)
Prepaid pension cost	\$ 59	26

Note 15 — Incentive Compensation Plans

The Incentive Compensation Plan provides for awards to key employees in recognition of outstanding contributions to the company's success. Awards, as approved by the Board of Directors, may be in the form of cash or shares of the company's common stock and may not exceed a specified percent by which net income exceeds an expressed percent of borrowed and invested capital, as defined by the plan. In anticipation of awards that may become payable under the plan, provisions of \$9 million, \$10 million and \$10 million were made against earnings in 1985, 1984 and 1983, respectively. The provisions were substantially less than the maximum permitted under the plan.

The Long-Term Incentive Compensation Plan provides for the granting of contingent awards to certain key employees as incentives to improve the company's long-term profitability and growth. The amount of awards to be paid is determined at the close of each performance period (three or more years) on the basis of performance measurement criteria established by the Board of Directors at the beginning of the performance period. The amount charged against earnings and credited to a reserve in anticipation of awards that may become payable under the plan was \$5 million, \$1 million and \$1 million in 1985, 1984 and 1983, respectively.

Note 16 — Other Financial Information

	Millions of Dollars Except Per Share Amounts		
	1985	1984	1983
Interest			
Incurred	\$897	360	311
Capitalized	51	46	64
Expensed	\$846	314	247
Maintenance and repairs — expensed	\$387	383	371
Research and development expenditures — expensed	\$107	124	114
Dividends declared and paid per share			
On common stock*			
Cash	\$.95	.78	.73
Preferred stock	1.36	—	—
On preferred stock — cash	1.04	—	—

*Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

Note 17 — Foreign Currency Gains and Losses

After-tax transaction gains and losses decreased earnings \$9 million in 1985 and increased earnings \$42 million and \$30 million in 1984 and 1983, respectively.

Note 18 – Segment and Geographic Information

The company is involved primarily in Petroleum and Chemicals operations. Petroleum operations are fully integrated and involve the exploration, production, processing, transportation and refining of crude oil and natural gas, together with the subsequent transportation and marketing of products derived therefrom. This segment also provides feedstock for the production of petrochemicals. Chemicals operations involve the manufacture and marketing of a broad range of petroleum-based chemical products. Miscellaneous operations are included in Other.

Sales and other operating revenues to outside customers and sales within Phillips by business segment and by geographic area are at market value. In computing operating profit, none of the following has been added or deducted: general corporate revenue and expenses, interest, unusual items and income taxes. The company's share of earnings of affiliated companies has been included with the segment and geographic area in which the affiliate operates.

Identifiable assets by business segment and geographic area, including investments in affiliated companies, are those assets that are used in the company's operations in each segment or area. Corporate assets are principally cash.

Intersegment and intergeographic sales are eliminated in determining consolidated revenue. Profit in inventory resulting from intercompany transfers has been eliminated from operating profit and identifiable assets of the producing operation.

Analysis of Results by Business Segment

Years Ended December 31	Millions of Dollars		
	1985	1984	1983
Sales and Other Operating Revenues to Outside Customers			
Petroleum			
Exploration and production	\$ 2,110	2,131	2,114
Gas and gas liquids	1,122	1,063	964
Refining, marketing and transportation	10,084	9,930	9,875
	13,316	13,124	12,953
Chemicals	2,266	2,351	2,255
Other	54	52	40
	\$15,636	15,527	15,248

Years Ended December 31	Millions of Dollars		
	1985	1984	1983
Sales within Phillips			
Petroleum			
Exploration and production	\$ 2,131	2,075	1,919
Gas and gas liquids	1,115	1,205	1,234
Refining, marketing and transportation	638	681	623
Eliminations (intra-segment)	(3,262)	(3,297)	(3,160)
	622	664	616
Chemicals	241	304	229
Other	33	35	35
	\$ 896	1,003	880

Summary of Income from Continuing Operations

Operating Profit			
Petroleum			
Exploration and production	\$ 1,879	1,797	1,910
Gas and gas liquids	291	344	510
Refining, marketing and transportation	342	203	187
	2,512	2,344	2,607
Chemicals	219	221	89
Other	(2)	(24)	(14)
Total operating profit	2,729	2,541	2,682
Other revenues	81	90	82
Nonoperating items	(2,214)	(1,794)	(2,004)
	\$ 596	837	760

Identifiable Assets

Petroleum			
Exploration and production	\$ 6,690	7,426	5,708
Gas and gas liquids	1,355	1,458	1,064
Refining, marketing and transportation	2,774	3,133	2,497
	10,819	12,017	9,269
Chemicals	1,315	1,498	1,499
Corporate and Other	1,749	2,775	1,861
Discontinued operations	162	665	459
	\$14,045	16,955	13,088

Depreciation, Depletion, Amortization and Retirements

Petroleum			
Exploration and production	\$ 716	585	278
Gas and gas liquids	101	88	74
Refining, marketing and transportation	105	100	97
	922	773	449
Chemicals	72	67	80
Corporate and Other	50	65	44
	\$ 1,044	905	573

Years Ended December 31

Millions of Dollars

	1985	1984	1983
Capital Expenditures – Properties, Plants and Equipment			
Petroleum			
Exploration and production	\$ 680	747	706
Gas and gas liquids	136	329	125
Refining, marketing and transportation	95	109	126
	911	1,185	957
Chemicals	45	77	64
Corporate and Other	104	106	107
	\$ 1,060	1,368	1,128

Analysis of Results by Geographic Area

Years Ended December 31

Millions of Dollars

	1985	1984	1983
Sales and Other Operating Revenues to Outside Customers			
United States	\$12,511	12,457	12,388
Norway	1,100	1,067	1,250
Other Europe	1,700	1,650	1,271
Africa	141	92	98
Other areas	184	261	241
	\$15,636	15,527	15,248

Sales within Phillips

United States	\$ 101	106	98
Norway	226	393	411
Other Europe	19	6	5
Africa	288	322	311
Other areas	23	35	29
	\$ 657	862	854

Operating Profit

United States	\$ 1,390	1,302	1,301
Norway	950	919	1,278
Other Europe	182	181	52
Africa	195	182	98
Other areas	12	(43)	(47)
	\$ 2,729	2,541	2,682

Identifiable Assets

United States	\$ 9,447	10,548	7,762
Norway	1,168	1,118	1,143
Other Europe	829	977	919
Africa	385	466	500
Other areas	305	406	444
Corporate and Other	1,749	2,775	1,861
Discontinued operations	162	665	459
	\$14,045	16,955	13,088

Export Sales	\$ 509	448	465
---------------------	--------	-----	-----

Selected Quarterly Financial Data

Millions of Dollars

	Sales and Other Operating Revenues*	Income from Continuing Operations before Income Taxes*	Net Income	Net Income Per Share of Common Stock**
1985				
First***	\$3,922	445	113	.25
Second***	3,939	408	117	.52
Third***	3,905	437	93	.38
Fourth	3,870	663	95	.39
1984				
First	3,916	609	193	.42
Second	3,987	550	231	.50
Third	3,682	477	217	.47
Fourth	3,942	482	169	.37

*Restated for discontinued operations.

**Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

***Quarterly earnings have been restated to reflect adoption of FASB Statements No. 87 and 88 effective January 1, 1985. Adoption of Statement No. 87 increased income from continuing operations before income taxes \$13 million each quarter, net income \$7 million each quarter, and net income per share \$.01 in the first quarter and \$.03 each in the second and third. Adoption of Statement No. 88 increased third quarter income from continuing operations before income taxes, net income and net income per share \$94 million, \$50 million and \$.23, respectively.

Due to unusual items in 1985, income from continuing operations before income taxes has been increased by \$40 million in the first quarter, decreased by \$82 million in the third quarter and increased by \$222 million in the fourth quarter. Originally the unusual item for the first quarter of 1985 was reported as a part of Other Revenues but was reclassified in the third quarter due to additional unusual items which made the cumulative amount material.

Oil and Gas Operations

Proved Reserves Worldwide

Years Ended
December 31

Years Ended December 31	Crude Oil					
	Millions of Barrels					
	United States	Norway	Other Europe	Africa	Other Areas	Total
Developed and Undeveloped End of 1982	369	197	45	106	3	720
Revisions of previous estimates	10	26	—	7	—	43
Improved recovery	10	58	—	—	—	68
Purchases of reserves in place	54	—	—	—	28	82
Extensions and discoveries	9	—	—	3	—	12
Production	(46)	(30)	(2)	(9)	(3)	(90)
End of 1983	406	251	43	107	28	835
Revisions of previous estimates	13	10	2	4	—	29
Improved recovery	4	—	—	—	—	4
Purchases of reserves in place	97	—	—	—	2	99
Extensions and discoveries	59	—	1	—	1	61
Production	(49)	(27)	(8)	(11)	(2)	(97)
End of 1984	530	234	38	100	29	931
Revisions of previous estimates	30	53	8	5	11	107
Improved recovery	5	—	—	—	—	5
Extensions and discoveries	6	—	1	—	3	10
Production	(56)	(23)	(9)	(11)	(2)	(101)
Sales of reserves in place	(49)	—	(2)	—	—	(51)
End of 1985	466	264	36	94	41	901
Developed End of 1982	301	190	45	95	2	633
End of 1983	322	189	43	97	28	679
End of 1984	386	176	37	88	27	714
End of 1985	373	194	36	84	36	723

- “Proved reserves” are those quantities of crude oil, natural gas liquids and natural gas which, upon analysis of geological and engineering data, appear with reasonable certainty to be recoverable in the future from known oil and gas reservoirs under existing economic and operating conditions. As additional information becomes available or conditions change, proved reserve estimates must be revised.
- “Developed reserves” are those portions of proved crude oil, natural gas liquids and natural gas reserves that are recoverable through existing well bores and production equipment and facilities.

- “Proved crude oil” includes quantities attributable to fluid injection pressure maintenance programs implemented in the Prudhoe Bay field in Alaska (25 million barrels) and being implemented in the Maureen field in the U.K. sector of the North Sea. In 1983 additional quantities were added for an improved recovery project in the Ekofisk field in the Norwegian North Sea (58 million barrels).
- “Proved crude oil” excludes reserves attributable to a long-term supply agreement. These reserves are located only in “Other Areas” and at the end of 1985 and 1984 were nine million and four million barrels, respectively. Quantities received during 1985 and 1984 were 1,643,000 and 220,000 barrels, respectively.

Years Ended
December 31

	Natural Gas				
	Billions of Cubic Feet				
	United States	Norway	Other Europe	Other Areas	Total
Developed and Undeveloped End of 1982	3,300	1,905	235	9	5,449
Revisions of previous estimates	44	(9)	(31)	—	4
Purchases of reserves in place	283	—	—	285	568
Extensions and discoveries	81	—	—	—	81
Production	(289)	(147)	(22)	(10)	(468)
Sales of reserves in place	(3)	—	—	—	(3)
End of 1983	3,416	1,749	182	284	5,631
Revisions of previous estimates	167	39	13	(6)	213
Purchases of reserves in place	434	—	109	1	544
Extensions and discoveries	196	—	—	5	201
Production	(286)	(154)	(23)	(10)	(473)
Sales of reserves in place	(2)	—	—	—	(2)
End of 1984	3,925	1,634	281	274	6,114
Revisions of previous estimates	(27)	(644)	23	(42)	(690)
Extensions and discoveries	57	—	53	37	147
Production	(322)	(128)	(26)	(11)	(487)
Sales of reserves in place	(53)	—	(148)	—	(201)
End of 1985	3,580	862	183	258	4,883
Developed End of 1982	3,129	1,857	235	9	5,230
End of 1983	3,241	1,732	182	269	5,424
End of 1984	3,596	1,634	246	258	5,734
End of 1985	3,292	825	177	209	4,503

- The 1985 revisions of previous estimates in Norway reserves are the result of the reinjection program to reduce subsidence in the Ekofisk field in the Norwegian North Sea.
- “Natural gas reserves” are computed at 14.65 pounds per square inch absolute and 60° Fahrenheit.

Years Ended
December 31

Years Ended December 31	Natural Gas Liquids			
	Millions of Barrels			
	United States	Norway	Other Areas	Total
Developed and Undeveloped End of 1982	120	55	—	175
Revisions of previous estimates	25	—	—	25
Purchases of reserves in place	9	—	1	10
Extensions and discoveries	1	—	—	1
Production	(11)	(5)	—	(16)
End of 1983	144	50	1	195
Revisions of previous estimates	(3)	3	—	—
Extensions and discoveries	1	—	—	1
Production	(13)	(4)	—	(17)
End of 1984	129	49	1	179
Revisions of previous estimates	(8)	7	—	(1)
Extensions and discoveries	1	—	—	1
Production	(12)	(5)	—	(17)
End of 1985	110	51	1	162
Developed				
End of 1982	118	54	—	172
End of 1983	140	50	1	191
End of 1984	129	49	1	179
End of 1985	109	51	1	161

Capitalized Costs Relating to Oil and Gas Producing Activities

At December 31	Millions of Dollars	
	1985	1984
Proved properties	\$8,211	8,356
Unproved properties	1,184	1,201
	9,395	9,557
Accumulated depreciation, depletion and amortization	3,413	2,953
	\$5,982	6,604

- "Capitalized Costs Relating to Oil and Gas Producing Activities" includes the cost of equipment and facilities that support only oil and gas producing activities. Not included are investments in natural gas liquids extraction plants and related systems, as well as downstream manufacturing, distribution and marketing facilities required to convert raw petroleum liquids and natural gas into consumable products.
- "Proved properties" includes capitalized costs for oil and gas leaseholds holding proved petroleum liquids and natural gas reserves, wells and related equipment and facilities (including uncompleted well costs) and support equipment.

- "Unproved properties" includes capitalized costs for oil and gas leaseholds under exploration, including those where petroleum liquids and gas were found but not in quantities to be considered proved reserves.

Costs Incurred in Oil and Gas Property Acquisition, Exploration and Development Activities

	Millions of Dollars			
	Acquisition	Exploration	Development	Total
1985				
United States	\$ 25	234	348	607
Norway	—	14	107	121
Other Europe	—	48	16	64
Africa	—	15	19	34
Other areas	2	54	11	67
	\$ 27	365	501	893
1984				
United States	\$1,570	317	284	2,171
Norway	—	26	86	112
Other Europe	106	51	12	169
Africa	7	20	41	68
Other areas	14	55	8	77
	\$1,697	469	431	2,597
1983				
United States	\$ 934	292	219	1,445
Norway	—	30	49	79
Other Europe	10	58	57	125
Africa	—	50	40	90
Other areas	156	68	5	229
	\$1,100	498	370	1,968

- "Costs incurred" includes both capitalized and expensed items.
- "Property acquisition" includes the costs of acquiring undeveloped oil and gas leaseholds. In 1984 and 1983, respectively, it also includes proved properties of approximately \$1.2 billion and \$751 million in the United States and approximately \$110 million and \$144 million in the remaining areas resulting from the acquisition of Aminoil in 1984 and General American Oil Company in 1983. Property acquisition costs for 1984 have been restated to reflect the final allocation of the purchase price of Aminoil to proved properties.
- "Exploration" includes geological and geophysical expenses, cost of carrying and retaining undeveloped leaseholds, and exploratory drilling costs.
- "Development" includes the cost of drilling and equipping development wells and building related production facilities for extracting, treating, gathering and storing petroleum liquids and natural gas.

Oil and Gas Statistics

Net Crude Oil and Natural Gas Liquids Production

	1985	1984	1983
	Thousands of Barrels Daily		
Crude Oil			
United States	154	136	127
Norway	63	72	81
Other Europe	24	24	5
Africa	32	28	27
Other areas	8	8	7
	281	268	247

Natural Gas Liquids

United States Plant			
Production from leasehold gas	31	33	27
Production from purchased gas	161	147	134
	192	180	161
Norway production from leasehold gas	12	12	14
	204	192	175
	485	460	422

Net Natural Gas Production

	Millions of Cubic Feet Daily		
United States	876	843	799
Norway	327	364	381
Other Europe	72	62	62
Other areas	31	19	24
	1,306	1,288	1,266

Average Production (Lifting) Costs* – Per Equivalent Barrel of Oil

	1985	1984	1983
United States	\$7.11	6.58	6.97
Norway	4.82	4.58	5.09
Other Europe	1.97	2.02	3.04
Africa	5.57	7.39	7.55
Other areas	5.20	10.01	9.82

*"Production (lifting) costs" consists of costs incurred to operate and maintain wells and related equipment and facilities used in the production of petroleum liquids and natural gas. Also included is the U.S. crude oil excise tax of \$127 million, \$137 million and \$186 million in 1985, 1984 and 1983, respectively. It does not include depreciation, depletion and amortization of capitalized acquisition, exploration and development costs.

Average Sales Prices

Crude Oil – Per Barrel	1985	1984	1983
United States	\$24.56	26.25	26.64
Norway	27.55	29.44	30.44
Other Europe	27.79	29.20	29.47
Africa	27.72	28.93	29.26
Other areas	15.13	24.43	28.02
Natural Gas Liquids – Per Barrel			
United States	13.13	14.80	17.15
Norway	15.03	13.74	16.45
Other Europe	24.27	25.62	27.86
Natural Gas – Per Thousand Cubic Feet			
United States lease	2.06	1.94	1.87
United States lease and natural gas liquids plant*	2.23	2.31	2.21
Norway	4.30	4.02	4.32
Other Europe	1.69	1.29	1.28
Other areas	1.68	1.87	1.39

*Excludes sales of liquefied natural gas from Kenai, Alaska.

Acreage at December 31, 1985

	Thousands of Acres	
	Gross	Net
Developed		
United States	2,773	1,842
Norway	95	23
Other Europe	13	3
Africa	108	34
Other areas	411	125
	3,400	2,027

Undeveloped

United States	8,492	5,351
Norway	1,132	283
Other Europe	2,820	904
Africa	2,157	739
Asia	7,280	1,901
Canada	15,312	4,244
	37,193	13,422

Wells Completed*

	Gross			Net Productive			Net Dry		
	1985	1984	1983	1985	1984	1983	1985	1984	1983
Exploratory									
United States	111	122	91	16	18	17	43	54	34
Norway	1	3	4	—	—	—	—	1	1
Other Europe	6	2	4	—	—	—	2	—	—
Africa	6	1	4	—	—	—	2	—	2
Other areas	3	7	11	—	—	—	1	4	4
	127	135	114	16	18	17	48	59	41

Development

United States	1,474	1,277	828	208	242	167	18	27	36
Norway	2	3	3	1	1	1	—	—	—
Other Europe	—	1	—	—	—	—	—	—	—
Africa	—	6	11	—	2	3	—	1	—
Other areas	20	63	7	5	19	2	2	4	1
	1,496	1,350	849	214	264	173	20	32	37

*Excludes farmout arrangements.

Wells at Year-End 1985

	In Progress*		Productive**			
	Gross	Net	Oil		Gas	
			Gross	Net	Gross	Net
United States	306	54	35,286	9,077	5,642	2,805
Norway	1	—	85	31	29	11
Other Europe	22	3	12	4	27	5
Africa	3	1	181	45	3	1
Other areas	32	11	1,193	352	320	93
	364	69	36,757	9,509	6,021	2,915

*Includes wells which have been temporarily suspended.

**Includes 1,288 gross and 496 net multiple completion wells.

Results of Operations for Oil and Gas Producing Activities

	Millions of Dollars					Total
	United States	Norway	Other Europe	Africa	Other Areas	
1985						
Sales	\$ 977	593	283	26	66	1,945
Transfers	1,112	634	—	301	—	2,047
Total revenues	2,089	1,227	283	327	66	3,992
Production (lifting) costs	772	230	26	65	26	1,119
Exploration expenses	153	11	25	10	28	227
Depreciation, depletion, amortization and retirements	587	139	102	69	22	919
	577	847	130	183	(10)	1,727
Provision for income taxes	260	672	79	201	—	1,212
Results of Operations for Producing Activities	\$ 317	175	51	(18)	(10)	515
1984						
Sales	\$ 985	622	284	26	89	2,006
Transfers	949	761	—	292	—	2,002
Total revenues	1,934	1,383	284	318	89	4,008
Production (lifting) costs	659	245	25	77	42	1,048
Exploration expenses	196	14	29	11	43	293
Depreciation, depletion, amortization and retirements	518	141	101	53	49	862
	561	983	129	177	(45)	1,805
Provision for income taxes	264	806	107	184	1	1,362
Results of Operations for Producing Activities	\$ 297	177	22	(7)	(46)	443
1983						
Sales	\$ 1,018	834	77	10	80	2,019
Transfers	791	764	8	282	—	1,845
Total revenues	1,809	1,598	85	292	80	3,864
Production (lifting) costs	657	296	18	74	38	1,083
Exploration expenses	154	11	42	18	40	265
Depreciation, depletion, amortization and retirements	487	(17)	5	109	69	653
	511	1,308	20	91	(67)	1,863
Provision for income taxes	229	1,058	(4)	172	3	1,458
Results of Operations for Producing Activities	\$ 282	250	24	(81)	(70)	405

- “Sales” excludes revenues received from operation of natural gas liquids extraction plants and related gas systems. Transfers are valued at prices which approximate market prices.
- “Production (lifting) costs” consists of costs incurred to operate and maintain wells and related equipment and facilities used in the production of petroleum liquids and natural gas. Also included is the U.S. crude oil excise tax of \$127 million, \$137 million and \$186 million in 1985, 1984 and 1983, respectively. It does not include depreciation, depletion and amortization of capitalized acquisition, exploration and development costs.
- “Exploration expenses” primarily includes geological and geophysical expenses and the cost of carrying and retaining undeveloped leaseholds.
- “Provision for income taxes” is computed by adjusting each country’s income before income tax for permanent differences related to the oil and gas producing activities that are reflected in the company’s consolidated income tax expense for the period and then multiplying the result times the country’s statutory tax rate.
- “Results of operations for producing activities” should not be equated to net income since no deduction has been made for such costs and expenses as distribution, selling, administrative and interest.

Standardized Measure of Discounted Future Net Cash Flows Relating to Proved Oil and Gas Reserve Quantities

	Millions of Dollars					
	United States	Norway	Other Europe	Africa	Other Areas	Total
1985						
Future cash inflows	\$18,492	11,142	1,330	2,622	1,463	35,049
Future production costs	(6,642)	(1,982)	(136)	(341)	(576)	(9,677)
Future development costs	(1,513)	(803)	(85)	(74)	(174)	(2,649)
Future income tax provisions	(3,825)	(6,509)	(846)	(1,945)	(263)	(13,388)
Future net cash flows	6,512	1,848	263	262	450	9,335
10% annual discount	(3,289)	(898)	(70)	(93)	(262)	(4,612)
Discounted future net cash flows	\$ 3,223	950	193	169	188	4,723

1984						
Future cash inflows	\$ 20,649	13,784	1,560	2,778	1,353	40,124
Future production costs	(7,078)	(2,572)	(173)	(581)	(660)	(11,064)
Future development costs	(2,445)	(942)	(98)	(98)	(100)	(3,683)
Future income tax provisions	(3,833)	(8,102)	(801)	(1,779)	(194)	(14,709)
Future net cash flows	7,293	2,168	488	320	399	10,668
10% annual discount	(3,657)	(986)	(106)	(107)	(211)	(5,067)
Discounted future net cash flows	\$ 3,636	1,182	382	213	188	5,601

1983						
Future cash inflows	\$ 16,504	14,502	1,482	3,143	1,184	36,815
Future production costs	(5,561)	(2,891)	(221)	(600)	(514)	(9,787)
Future development costs	(1,525)	(860)	(88)	(142)	(4)	(2,619)
Future income tax provisions	(4,114)	(8,421)	(646)	(2,105)	(271)	(15,557)
Future net cash flows	5,304	2,330	527	296	395	8,852
10% annual discount	(2,731)	(992)	(44)	(110)	(172)	(4,049)
Discounted future net cash flows	\$ 2,573	1,338	483	186	223	4,803

- "Future net cash flows" is computed using year-end prices and costs and year-end statutory tax rates that relate to existing proved oil and gas reserves in which the company has mineral interests.

Oil and gas sales prices have declined since year-end 1985. If such declines prove to be substantial and of long duration, they could cause a significant variation in future net cash flows.

The following are the sources of change in the standardized measure of discounted future net cash flows during 1985, 1984 and 1983.

	Millions of Dollars		
	1985	1984	1983
Sales and transfers of oil and gas produced, net of production costs	\$(2,873)	(2,960)	(2,781)
Net changes in prices and production costs	757	(157)	(1,413)
Extensions, discoveries, additions and improved recovery, less related costs	258	341	496
Development costs incurred during the period	501	431	370
Purchases of reserves in place	—	1,010	961
Sales of reserves in place	(554)	—	—
Revisions of previous quantity estimates and other	(585)	812	8
Accretion of discount	1,307	1,236	1,338
Net change in income taxes	311	85	652
	\$ (878)	798	(369)

Supplementary Information on Changing Prices

The following supplementary data are provided to demonstrate the effects of inflation on Phillips. The primary financial statements (pages 31–33), prepared on a historical cost basis according to generally accepted accounting principles, report transactions in terms of actual dollars received or expended at the time regardless of the relative purchasing power of the dollar. In the accompanying schedules, historical dollar financial data are compared with data comprehensively restated at estimated current cost, which gives effect to changes in prices of specific goods and services used by the company.

Under the current cost method, estimated current costs and prices, industry-related published indices and internally generated indices are used, as appropriate, to translate historical costs into 1985 end-of-year dollars. No consideration has been given to possible replacement of assets using different types, different locations or with improved operating cost efficiencies. Prior year information has been restated to year-end 1985 dollars using the Consumer Price Index – All Urban Consumers (CPI-U) as published by the U.S. Department of Labor to provide comparative data. Although current cost estimates are highly subjective and imprecise, they can be viewed as general indicators of the impact of changing prices on the company and its operations.

Current cost net income is lower than historical cost net income because: (1) the historical dollar capital recovery charge (depreciation, depletion, amortization and retirements) is far less than current dollar cost of capital asset maintenance, and (2) the provision for income taxes does not decline with reductions in income before income taxes caused by adjustments for current cost. The provision for income taxes included for current cost is unchanged from the amount reported in the primary statement of income, except for restatement to end-of-year dollars. The effective tax rate for 1985 under the current cost method, 125 percent, is significantly higher than statutory rates since income taxes are based on reported historical income rather than on current cost adjusted results.

Comparative Summary Financial Data

	Millions of Dollars ⁽¹⁾			
	1985		1984 ⁽²⁾	
	Historical	Current Cost	Historical	Current Cost
Summary Balance Sheet				
Properties, Plants and Equipment (net)	\$10,281	14,597	11,188	20,244
Inventories	642	1,336	871	1,730
Other Assets	3,122	3,437	4,896	5,385
Liabilities	12,120	12,155	10,331	10,752
Redeemable Preferred Stock	281	281	—	—
Common Stockholders' Equity	1,644	6,934	6,624	16,607
Summary of Income from Continuing Operations				
Revenues	\$15,800	16,037	15,746	16,564
Costs and Expenses				
Costs and operating expenses	11,319	11,508	11,528	12,149
Depreciation, depletion, amortization and retirements	1,044	1,417	905	1,641
Other	1,484	2,010	1,195	1,258
Provision for Income Taxes	1,357	1,379	1,281	1,348
Income (Loss) from Continuing Operations	\$ 596	(277)	837	168

See footnotes on page 51.

Five-Year Comparison of Selected Supplementary Financial Data

Years Ended December 31	Millions of Dollars Except Per Share Amounts ⁽¹⁾				
	1985	1984	1983	1982	1981
Revenues ⁽²⁾					
Historical	\$15,800	15,746	15,409	15,890	16,287
Current cost	16,037	16,564	16,896	17,983	19,556
Income (Loss) from Continuing Operations ⁽²⁾					
Historical	\$ 596	837	760	701	940
Current cost	(277)	168	37	(167)	367
Income (Loss) from Continuing Operations Per Common Share ⁽²⁾⁽³⁾					
Historical	\$ 2.07	1.81	1.65	1.53	2.06
Current cost	(1.05)	.36	.08	(.36)	.80
Common Stockholders' Equity					
Historical	\$ 1,644	6,624	6,149	5,773	5,481
Current cost	6,934	16,607	17,510	18,231	17,739
Unrealized Gains Attributable to Net Monetary Amounts Owed	\$ 271	189	145	126	186
Increase (Decrease) in Current Cost of Inventories and Properties, Plants and Equipment ⁽²⁾	\$ (3,329)	80	153	1,807	1,677
Effect of Increase in General Price Level ⁽²⁾	769	824	791	763	1,522
Current Cost over (under) General Price Level ⁽²⁾	\$ (4,098)	(744)	(638)	1,044	155
Cash Dividends Declared Per Common Share ⁽³⁾					
Historical	\$.95	.78	.73	.73	.73
Year-end 1985 dollars	.97	.82	.81	.83	.88
Market Price Per Common Share — end of year ⁽³⁾					
Historical	\$ 12.13	14.92	11.50	10.88	13.50
Year-end 1985 dollars	12.13	15.48	12.40	12.18	15.70
Consumer Price Index — average for year	322.2	311.1	298.4	289.1	272.4
Consumer Price Index — end of year	327.4	315.5	303.5	292.4	281.5

(1) Except for historical amounts, all items are stated in 1985 end-of-year dollars.

(2) Restated for discontinued operations.

(3) Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

Selected Financial Data

FIVE-YEAR FINANCIAL REVIEW

	Millions of Dollars Except as Indicated				
	1985	1984*	1983*	1982*	1981*
Selected Income Data					
Sales and other operating revenues	\$15,636	15,527	15,248	15,697	15,965
Other revenues (including equity in earnings of affiliated companies)	164	219	161	193	322
Net income	418	810	721	646	879
Selected Balance Sheet Data					
Current assets	3,144	4,602	2,895	2,900	3,038
Properties, plants and equipment (net)	10,281	11,188	9,170	8,165	7,203
Total assets	14,045	16,955	13,088	12,073	11,252
Current liabilities	3,110	5,345	2,877	2,691	3,227
Long-term debt	6,547	2,839	2,242	1,955	1,100
Deferred income taxes	1,673	1,433	1,210	838	710
Redeemable preferred stock	281	—	—	—	—
Common stockholders' equity	1,644	6,624	6,149	5,773	5,481
Selected Statement of Changes in Financial Position Data					
Funds from continuing operations	2,129	2,233	2,016	1,952	1,997
Capital expenditures					
Exploration and Production	680	747	706	1,080	1,607
Gas and Gas Liquids	136	329	125	240	313
Petroleum Products	95	109	126	389	330
Chemicals	45	77	64	148	166
Corporate and Other	104	106	107	212	173
Purchase of net noncurrent assets of acquired companies	—	1,784	1,229	—	—
Dividends paid					
On common stock	542	362	337	336	335
On preferred stock	12	—	—	—	—
Other Data					
Net income					
As percent of total revenues	2.6	5.1	4.7	4.1	5.4
As percent of average total assets	2.7	6.0	5.5	5.3	8.2
As percent of average common stockholders' equity	14.7	12.7	12.3	11.6	16.9
Percent of total revenues from sales outside U.S.	21.1	20.6	19.3	20.0	22.7
Percent of long-term debt to common stockholders' equity	79.9	30.0	26.7	25.3	16.7
Per average common share outstanding**					
Net income	\$ 1.44	1.75	1.57	1.41	1.93
Cash dividends paid	\$.95	.78	.73	.73	.73
Common stockholders' equity per share**	\$ 7.24	14.28	13.38	12.57	12.01
Common shares outstanding at year-end (in millions)**	227.1	463.9	459.7	459.4	456.5
Common stockholders at year-end (in thousands)	83.3	113.4	119.8	123.1	120.4
Total payroll including employee benefits	\$ 1,130	1,164	1,192	1,278	1,178
Employees at year-end (in thousands)	25.3	29.3	28.4	29.6	34.5

*Restated for discontinued operations.

**Adjusted for three-for-one stock split in the form of a 200-percent common stock dividend effective May 31, 1985.

Operating Summary

Exploration and Production	1985	1984	1983	1982	1981
Net Crude Oil Production	Thousands of Barrels Daily				
United States	154	136	127	112	116
Norway	63	72	81	86	100
Other Europe	24	24	5	—	—
Africa	32	28	27	26	24
Canada	4	4	4	—	—
Southeast Asia	—	3	3	1	5
Latin America	4	1	—	—	—
	281	268	247	225	245

Net Natural Gas Liquids Production					
Norway	12	12	14	12	11
Gas and Gas Liquids production	192	180	161	148	152
	204	192	175	160	163

Net Natural Gas Production	Millions of Cubic Feet Daily				
United States	876	843	799	789	899
Norway	327	364	381	404	407
Other Europe	72	62	62	67	81
Canada	31	19	24	—	1
	1,306	1,288	1,266	1,260	1,388

Net Oil and Gas Acreage	Millions of Acres				
United States	7	9	8	8	10
Europe	1	2	2	2	2
Africa	1	2	2	10	14
Canada	4	4	2	2	2
Southeast Asia	2	6	7	9	19
Latin America	—	1	2	1	15
Australia and New Zealand	—	—	1	1	4
	15	24	24	33	66

Oil and Gas Wells	Net Wells				
United States					
Oil	9,077	9,207	8,210	6,439	6,396
Gas and condensate	2,805	2,744	2,573	2,323	2,293
Outside United States					
All wells	542	561	473	132	127
	12,424	12,512	11,256	8,894	8,816

Well Completions					
United States					
Exploratory	59	72	51	43	43
Development	226	269	203	258	243
Outside United States					
Exploratory	5	5	7	20	32
Development	8	27	7	5	9
	298	373	268	326	327

FIVE-YEAR OPERATING REVIEW

Gas and Gas Liquids	1985	1984	1983	1982	1981
Natural Gas Purchases	Millions of Cubic Feet Daily				
United States					
Purchases from unaffiliated entities	1,542	1,367	1,222	1,215	1,220
Purchases from consolidated operations	378	396	397	388	422
	1,920	1,763	1,619	1,603	1,642

Natural Gas Processed	2,160	1,858	1,715	1,700	1,799
------------------------------	-------	-------	-------	-------	-------

Natural Gas Sales					
United States					
Natural gas	1,044	895	756	811	784
Liquefied natural gas	101	101	101	96	107
	1,145	996	857	907	891

Net Natural Gas Liquids Production*	Thousands of Barrels Daily				
United States Plant					
Production from leasehold gas	31	33	27	28	31
Production from purchased gas	161	147	134	120	121
	192	180	161	148	152

*See Exploration and Production operations above for total company production.

Petroleum Products					
Refinery Capacity					
United States					
Crude Oil	300	295	295	374*	380*
Natural gas liquids	223	218	228	228	228
	523	513	523	602	608

*Includes the 80,000-barrel-a-day Kansas City refinery shut down August 1, 1982.

Refinery Runs					
United States					
Crude oil	292	288	260	277	285
Natural gas liquids	195	193	187	179	167
	487	481	447	456	452

Petroleum Products Sold					
United States					
Automotive gasoline	239	218	212	216	209
Aviation fuels	31	26	23	29	23
Distillates	91	82	81	77	77
Liquefied petroleum gas	108	95	98	108	94
Other products	59	35	38	31	43
	528	456	452	461	446
Outside United States	47	51	53	52	55
	575	507	505	513	501

Marketing Outlets (in thousands)	12	11	12	14	14
--	----	----	----	----	----

Board of Directors and Principal Officers

As of March 1, 1986

Directors

George B. Beitzel, 57, Senior Vice President and Director of International Business Machines Corporation, a manufacturer of computers and office equipment, Armonk, N.Y. Elected to Phillips board 1980. Also a director of Flight Safety International, Inc., Rohm and Haas Company, Bankers Trust New York Corporation and its subsidiary, Bankers Trust Company. (1),(3),(5)

Michael N. Chetkovich, 69, Consultant to the Dean and Lecturer at the School of Business Administration, University of California, Berkeley, and former managing partner in the accounting firm of Deloitte Haskins & Sells, Atherton, Calif. Elected to Phillips board 1980. Also a director of American International Group, Inc. and McDonnell Douglas Corporation. (2),(5)

Glenn A. Cox, 56, President and Chief Operating Officer. Elected to Phillips board 1982. Also a director of BancOklahoma Corp. (1)

James B. Edwards, 58, President of the Medical University of South Carolina and former U.S. Secretary of Energy, Charleston, S.C. Elected to Phillips board 1983. Also a director of J.P. Stevens & Co., Inc., The South Carolina National Bank, Burris Chemical, Inc. and Telecommunications Systems, Inc. (1),(3),(4)

Robert F. Froehlke, 63, Chairman of the Board of Directors of The Equitable Life Assurance Society of the United States, New York, N.Y. Elected to Phillips board 1984. Also a director of Rexnord, Inc. and Square D Company. (3),(4)

E. Douglas Kenna, 61, Partner of G.L. Ohrstrom & Company, a private investment group, Palm Beach, Fla. Elected to Phillips board 1977. Also a director of Burnley Corporation, Carlisle Corporation, Fleet Financial Group and Heritage Communications Corporation. (3),(4)

C.M. Kittrell, 59, Executive Vice President. Elected to Phillips board 1971. Also a director of First Bancshares, Inc. and its subsidiary, First National Bank in Bartlesville.

Melvin R. Laird, 63, Senior Counsellor for National and International Affairs for The Reader's Digest Association, Inc., Washington, D.C. Elected to Phillips board 1976. Former nine-term U.S. Congressman, Secretary of Defense and Presidential Counsellor. Also a director of Northwest Airlines, Inc., Chicago Pneumatic Tool Co., Metropolitan Life Insurance Company, Science Applications International Corporation, Communications Satellite Corporation, Martin Marietta Corporation, Investors Group of Companies and Public Oversight Board of the American Institute of Certified Public Accountants. (4),(5)

Carol C. Laise, 68, Former Director General of the U.S. Foreign Service in the State Department and former U.S. Ambassador to Nepal, Washington, D.C. Elected to Phillips board 1979. Also a director of the American Security Bank. (2),(5)

David B. Meeker, 60, Former Chairman of the Board of Directors of Hobart Corporation, a manufacturer of food equipment and home appliances, Troy, Ohio. Elected to Phillips board 1976. Also a director of Armco Inc.; Bank One, Dayton, N.A.; Dayton Power and Light Company; J.C. Penney Company, Inc.; Square D Company, and Sterling Drug Inc. (3),(4)

C. J. Silas, 53, Chairman of the Board of Directors and Chief Executive Officer. Elected to Phillips board 1982. Also a director of The First National Bank and Trust Company of Tulsa. (1)

R.G. Wallace, 59, Executive Vice President. Elected to Phillips board 1982. Also a director of UBT Bancorp, Inc. and its subsidiary, Union Bank and Trust Company, and Valmont Industries, Inc.

W. Clarke Wescoe, 65, Retired Chairman of the Board of Directors of Sterling Drug Inc., a diversified pharmaceutical company, New York, N.Y. Elected to Phillips board 1963. Also a director of Hallmark Cards Incorporated and Irving Bank Corporation and its subsidiary, Irving Trust Company. (1),(2),(3)

Dolores D. Wharton, 58, President of The Fund for Corporate Initiatives, Inc., a nonprofit organization that provides business internships and executive training for minorities and women, Albany, N.Y. Elected to Phillips board 1976. Also a director of Gannett Co., Inc., Kellogg Company and Golub Corporation. (2),(5)

Francis M. Wheat, 65, A Senior Partner in the law firm of Gibson, Dunn & Crutcher, Los Angeles, Calif. Elected to Phillips board 1976. (2),(5)

(1) Member Executive Committee

(2) Member Audit Committee

(3) Member Compensation Committee

(4) Member Nominating Committee

(5) Member Public Policy Committee

Management and Board of Directors Changes

Officers

C.J. Silas, 53, Chairman of the Board of Directors and Chief Executive Officer; officer since 1976.

Glenn A. Cox, 56, President and Chief Operating Officer; officer since 1974.

C.M. Kittrell, 59, Executive Vice President; officer since 1966.

L.M. Rickards, 58, Executive Vice President; officer since 1977.

R.G. Wallace, 59, Executive Vice President; officer since 1977.

R.E. Bonnell, 55, Senior Vice President Finance and Treasurer; officer since 1970.

William G. Paul, 55, Senior Vice President and General Counsel; officer since 1985.

K.L. Smalley, 56, Senior Vice President; officer since 1980.

Other Corporate Officers

W. E. Barr, Vice President Engineering and Services

C. L. Bowerman, Vice President Marketing Petroleum Products

J. Thomas Boyd, Vice President Public Affairs

C. F. Cook, Vice President Research and Development

J. W. O'Toole, Vice President and General Tax Officer

Richard I. Robinson, Vice President Refining

John N. Scott, Vice President Federal Relations

Ray G. Steiner, Vice President Supply and Transportation

W. R. Thomas, Vice President Human Resources

B. M. Thompson, Vice President Planning and Development

J. Bryan Whitworth, Vice President Government Relations

W. E. Thomas, Comptroller

L. E. Burnham, General Auditor

G. C. Meese, Secretary

J. M. Doyle, Assistant Treasurer

J. J. Mulva, Assistant Treasurer

R. H. Schultz, Assistant Treasurer

J. G. Wilson, Assistant Comptroller

L. F. Francis, Assistant General Tax Officer

D. L. Cone, Assistant Secretary

On April 30, 1985, C.J. Silas was elected chairman and chief executive officer and Glenn A. Cox was elected president and chief operating officer. Silas, formerly president and chief operating officer, succeeded Wm. C. Douce, who retired May 1 at normal retirement age 65. Cox, formerly executive vice president, succeeded Silas.

Five officers were elected to new positions on July 8. L. M. Rickards, formerly senior vice president exploration and production, was elected executive vice president over those operations. Kenneth L. Smalley, previously vice president minerals, was elected senior vice president gas and gas liquids. R. E. Bonnell, formerly vice president and treasurer, was elected senior vice president finance and treasurer. Ray G. Steiner, who previously was vice president services, was elected vice president supply and transportation. W. E. Barr, formerly vice president engineering, was elected vice president engineering and services.

A number of officers took advantage of an enhanced early retirement program for senior executives 62 years and older. R. G. Askew, senior vice president chemicals, retired from the company on July 1. Gordon D. Goering, senior vice president petroleum products, elected to take early retirement on Dec. 1. Kenneth Heady, senior vice president gas and gas liquids and property tax, real estate and claims, retired effective Jan. 1, 1986. Two vice presidents also retired under the early retirement program. John E. Harris Jr., petroleum supply, and Dr. Paul W. Tucker, gas and gas liquids, both retired Aug. 1.

Stockholder Information

Form 10-K

Copies of the company's annual report on Form 10-K as filed with the Securities and Exchange Commission may be obtained without charge by writing to G. C. Meese, Secretary, Phillips Petroleum Company, Bartlesville, Okla. 74004.

Annual Contributions Report

Copies of the company's Annual Contributions Report may be obtained without charge by writing to G.C. Meese, Secretary, Phillips Petroleum Company, Bartlesville, Okla. 74004.

Information Requests

Should you have questions about the information in this annual report or about the company, please contact Phillips investor relations office in New York City (212/397-9766) or Bartlesville (918/661-5139).

Questions regarding stockholder records, stock certificates, dividend checks or the dividend reinvestment plan should be directed to Phillips stockholder records section in Bartlesville. Call toll free 1-800-356-0066. In Oklahoma, call toll free 1-800-722-0660.

Annual Meeting

The annual meeting of stockholders will be held at 10 a.m., April 29, 1986, at the Hyatt Regency Houston Hotel, 1200 Louisiana Street, Houston, Texas. Notice of the meeting and proxy material are being sent to all stockholders.

Principal Offices

Bartlesville, Okla. 74004

630 Fifth Avenue
New York, N.Y. 10111

306 South State Street
Dover, Del. 19901

Stock Transfer Offices

Manufacturers Hanover Trust Company
Corporate Trust
450 West 33rd Street
New York, N.Y. 10001

Montreal Trust Company
15 King Street West
Toronto, Ontario
Canada M5H 1B4

Registrars

Manufacturers Hanover Trust Company
Corporate Trust
450 West 33rd Street
New York, N.Y. 10001

Canada Permanent Trust Company
20 Eglinton Avenue West
Toronto, Ontario
Canada M4R 2E2

Selected Subsidiaries

Applied Automation Inc.
Phillips 66 Company
Phillips 66 Natural Gas Company
Phillips Driscopipe Inc.
Phillips Fibers Corporation
N.V. Phillips Petroleum Chemicals S.A.
Phillips Petroleum Company Europe-Africa
Phillips Petroleum Company Norway
Phillips Pipe Line Company
Phillips Puerto Rico Core Inc.
Philtankers Inc.
Provesta Corporation

NOTICE TO ALL PERSONS WHO ARE BROKERAGE CONCERNS OR OTHER NOMINEES LISTED AS STOCKHOLDERS OF PHILLIPS PETROLEUM COMPANY ON DECEMBER 4, 1984 OR AT ANY TIME THEREAFTER UP TO AND INCLUDING MARCH 29, 1985, OR WHO ARE LISTED AS STOCKHOLDERS ON MARCH 17, 1986, BUT WHO WERE OR ARE NOT THE BENEFICIAL OWNERS OF SUCH STOCK.

IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

ALBERT I. EDELMAN,	} <i>Plaintiff,</i>	} <i>Civil Action No. 7899</i>
v.		
PHILLIPS PETROLEUM COMPANY, <i>et al.</i> ,	} <i>Defendants.</i>	

FRED LOWENSCHUSS,	} <i>Plaintiff,</i>	} <i>Civil Action No. 7972</i>
v.		
THE OPTION CLEARING CORPORATION, <i>et al.</i> ,	} <i>Defendants.</i>	

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

IN RE PHILLIPS PETROLEUM SECURITIES LITIGATION	} Master File No. Misc. 85-75

Pursuant to Orders of the United States District Court for the District of Delaware and the Court of Chancery of the State of Delaware in and for New Castle County, enclosed herewith is a NOTICE OF PARTIAL SETTLEMENT, SETTLEMENT HEARINGS AND RELATED CLASS AND DERIVATIVE ACTION DETERMINATIONS, RIGHT TO BE EXCLUDED FROM CLASS, AND RIGHT TO APPEAR DIRECTED TO: (a) THE STOCKHOLDERS OF PHILLIPS PETROLEUM COMPANY AND (b) ALL PERSONS WHO WERE HOLDERS OF SHARES OF PHILLIPS PETROLEUM COMPANY COMMON STOCK AS OF DECEMBER 4, 1984 AND THEIR SUCCESSORS IN INTEREST OR TRANSFEREES, IMMEDIATE AND REMOTE, THROUGH THE CLOSE OF BUSINESS ON MARCH 29, 1985 (the "NOTICE"). You are listed on the records of Phillips Petroleum Company as a holder of stock to whom the enclosed NOTICE is directed. The Courts have ordered that this notice be mailed to all brokerage concerns and other nominees. Accordingly, you should mail copies of the enclosed NOTICE to the beneficial owners of any such shares not beneficially owned by you promptly.

To obtain additional copies of the NOTICE, please communicate with George C. Meese, Secretary, Phillips Petroleum Company, Bartlesville, Oklahoma 74004.

IN THE
COURT OF CHANCERY OF THE STATE OF DELAWARE
IN AND FOR NEW CASTLE COUNTY

ALBERT I. EDELMAN,

Plaintiff,

v.

PHILLIPS PETROLEUM COMPANY, a Delaware corporation, MESA
PETROLEUM COMPANY, a Delaware corporation, MESA PARTNERS, a
Texas partnership, MESA ASSET CO., a Delaware corporation, MESA
SOUTHERN CO., a Delaware corporation, GEORGE B. BEITZEL,
MICHAEL N. CHETKOVICH, GLENN A. COX, WILLIAM C. DOUCE, JAMES B.
EDWARDS, ROBERT F. FROEHLKE, E. DOUGLAS KENNA, C. M. KITTRELL,
MELVIN R. LAIRD, CAROL A. LAISE, DAVID B. MEEKER, C. J. SILAS,
R. G. WALLACE, W. CLARKE WESCOE, DOLORES D. WHARTON, and
FRANCIS M. WHEAT,

Defendants.

Civil Action No. 7899

FRED LOWENSCHUSS, Trustee of the Fred Lowenschuss Associates
Pension Plan,

Plaintiff,

v.

THE OPTION CLEARING CORPORATION, a Delaware corporation, THE
AMERICAN STOCK EXCHANGE, a New York corporation, PHILLIPS
PETROLEUM COMPANY, a Delaware corporation, GEORGE B. BEITZEL,
MICHAEL N. CHETKOVICH, GLENN A. COX, WILLIAM C. DOUCE, JAMES B.
EDWARDS, ROBERT F. FROEHLKE, E. DOUGLAS KENNA, C. M. KITTRELL,
MELVIN R. LAIRD, CAROL A. LAISE, DAVID B. MEEKER, C. J. SILAS,
R. G. WALLACE, W. CLARKE WESCOE, DOLORES D. WHARTON, and
FRANCIS M. WHEAT,

Defendants.

Civil Action No. 7972

IN THE
UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF DELAWARE

IN RE PHILLIPS PETROLEUM
SECURITIES LITIGATION

} Master File No. Misc. 85-75 (RELATES TO THE FOLLOW-
ING CASES: Civil Actions Nos. 85-014 MMS, 85-045 MMS,
85-281 MMS, 85-401 MMS, 85-447 MMS and 85-537 MMS)

**NOTICE OF PARTIAL SETTLEMENT, SETTLEMENT
HEARINGS AND RELATED CLASS AND DERIVATIVE
ACTION DETERMINATIONS, RIGHT TO BE EXCLUDED
FROM CLASS, AND RIGHT TO APPEAR**

TO: (a) THE STOCKHOLDERS OF PHILLIPS PETROLEUM COMPANY AND (b) ALL PERSONS WHO WERE HOLDERS OF SHARES OF PHILLIPS PETROLEUM COMPANY COMMON STOCK AS OF DECEMBER 4, 1984 AND THEIR SUCCESSORS IN INTEREST OR TRANSFEREES, IMMEDIATE AND REMOTE, THROUGH THE CLOSE OF BUSINESS ON MARCH 29, 1985

THIS NOTICE IS GIVEN, pursuant to Rules 23 and 23.1 of The Court of Chancery of the State of Delaware in and for New Castle County (the "Chancery Court"), Orders of the Chancery Court entered March 5, 14 and 17, 1986, Rules 23 and 23.1 of The Federal Rules of Civil Procedure, and an Order of the United States District Court for the District of Delaware (the "Federal Court") entered March 17, 1986, to (a) the stockholders of Phillips Petroleum Company ("Phillips") and (b) all persons who were holders of shares of Phillips common stock as of December 4, 1984 and their successors in interest or transferees, immediate and remote, through the close of business on March 29, 1985 (the "Class").

This Notice is to advise of the proposed settlement (the "Settlement") of certain of the above-referenced actions (the "Actions") as to defendant Phillips and the individual defendants who are present or former members of the Board of Directors of Phillips (the "Individual Phillips Defendants"; Phillips and the Individual Phillips Defendants being sometimes collectively referred to herein as the "Phillips Defendants") in accordance with a Stipulation and Agreement of Compromise and Settlement between plaintiffs in the *Edelman* Chancery Action (as defined below) and in the *Hudson* Federal Actions (as defined below) (hereinafter collectively the "Plaintiffs") and the Phillips Defendants dated February 19, 1986, as amended and supplemented on March 14, 1986 (the "Stipulation"), the scheduling of final hearings on the Settlement in the Chancery Court for May 29, 1986 at 11:00 a.m. (EDT) and in the Federal Court for June 2, 1986 at 11:00 a.m. (EDT), and certain related matters as fully set forth below. Based upon a preliminary review, both the Chancery Court and the Federal Court preliminarily approved the Settlement as being within the range of reasonableness and meriting submission to the present Phillips stockholders and the members of the Class for their consideration. This preliminary approval is not final or conclusive and neither Court will finally approve the Settlement until the members of the Class and the present stockholders of Phillips are granted an opportunity to be heard by the Courts on the reasonableness and adequacy of the Settlement. Any Phillips stockholder or member of the Class who wishes to object or otherwise be heard with respect to the Settlement or matters relating thereto must make all filings described below under "THE HEARINGS" by May 19, 1986, with respect to the Settlement in the Chancery Court, and by May 23, 1986, with respect to the Settlement in the Federal Court. Any member of the Class who desires to be excluded from the Class must request exclusion as described below under "REQUESTS FOR EXCLUSION" by making a request in the prescribed form in time to be received by May 19, 1986.

The Actions include claims asserted against the Phillips Defendants, against Mesa Petroleum Co. ("Mesa") and other defendants related to Mesa and its affiliates, including Mesa Partners (collectively,

the "Mesa Defendants"), against Carl C. Icahn ("Icahn") and other defendants related to Icahn and his affiliates (collectively, the "Icahn Defendants") and against the Option Clearing Corporation ("OCC") and the American Stock Exchange ("AMEX"). As described below, the Settlement was negotiated between counsel for the Phillips Defendants and counsel for the Plaintiff in the *Edelman* Chancery Action (as defined below), William Prickett, Esquire, and lead counsel in the Consolidated Federal Actions (as defined below), Stephen D. Oestreich, Esquire, who was authorized by the Federal Court to conduct settlement negotiations with the Phillips Defendants on behalf of all representative plaintiffs in the Consolidated Federal Actions. Each of the plaintiffs in the *Hudson* Federal Actions (as defined below) and the *Irwin* Federal Action (as defined below) are also parties to the Settlement. The plaintiffs in the *Lowenschuss* Chancery Action (as defined below) and in the *Lawrence* Federal Action (as defined below) are not parties to the Settlement.

If the Settlement is finally approved, all class and derivative claims asserted against the Phillips Defendants in each of the Actions (including the Actions in which the named plaintiffs are not parties to the Settlement) will be dismissed with prejudice. The Settlement does not provide for the dismissal of the Actions as against the Mesa Defendants, the OCC or AMEX. However, certain claims against the Mesa Defendants and the Icahn Defendants that are alleged to be brought derivatively in the right of Phillips or that involve claims or allegations of wrongdoing by the Phillips Defendants (including any such derivative or class claims in the Actions in which the named plaintiffs are not parties to the Settlement) will also be dismissed with prejudice if the Settlement is approved. Accordingly, the Settlement will result in the dismissal with prejudice of all currently pleaded claims in the Actions against the Icahn Defendants. However, the plaintiffs in the Actions may seek leave to amend their complaints to allege claims against the Icahn Defendants that are not barred by the Settlement. The giving of this Notice is not meant to imply that there has been any violation of the law by any of the defendants.

THE ACTIONS

The Edelman Chancery Action

On December 4, 1984, Mesa announced that Mesa Partners had acquired 5.8% of the outstanding shares of Phillips common stock, and intended to commence a tender offer to purchase up to an additional 14.9% of the outstanding shares at a price of \$60 per share. In its Schedule 13D dated December 5, 1984 (the "Schedule 13D"), Mesa Partners stated that its intent was to obtain control of Phillips and that, if it were to obtain control, it intended to propose a merger or other business combination pursuant to which the holders of the remaining shares would receive a combination of cash and securities having an aggregate value "approximately equal" to \$60 per share. The Schedule 13D stated that Mesa Partners "has not formulated any specific proposal" and that "there is no assurance that any such transaction will be proposed" by Mesa Partners. The Schedule 13D also stated that "... neither the partnership nor any of its affiliates will sell any [common shares] owned by it or them back to the Company except on an equal basis with all other stockholders." Mesa Partners also disclosed in the Schedule 13D its intention to solicit written consents of stockholders of Phillips to remove Phillips' Board of Directors and to elect Mesa Partners' designees to a majority of the Board positions. On December 16, 1984 the Phillips Board of Directors concluded that the Mesa Partners proposal was contrary to the best interests of Phillips and its stockholders and determined to oppose that proposal. The attempt by Mesa Partners to take control of Phillips was ended by an agreement dated December 23, 1984 between Mesa Partners and its affiliates and Phillips (the "Phillips/Mesa Agreement"). Pursuant to the Phillips/Mesa Agreement, Phillips agreed to submit a recapitalization of

the company's outstanding common stock to its stockholders for their approval (the "Recapitalization"), and Mesa Partners and its affiliates agreed to a 15-year standstill and the sale or repurchase of its stock in Phillips at a price of \$53 per share, the value that Phillips believed to be the approximate value per share of the securities which would be issued in connection with the Recapitalization (which valuation is disputed by the plaintiffs). As originally structured, the Recapitalization consisted of three basic components to be submitted to the stockholders as a single package: (1) 38% of Phillips' common stock would be reclassified into preferred stock to be immediately exchanged for debt securities designed to have a value of \$60 per share; (2) Phillips would create an Employee Incentive Stock Ownership Plan ("EISOP") to purchase up to 32 million Phillips common shares at the market price and the company would spend \$1 billion in the following year to purchase its common stock in the open market at prices not to exceed \$50 per share; and (3) the Phillips certificate of incorporation would be amended to provide for a classified board of directors and the elimination of the stockholders' ability to act by written consent.

On January 2, 1985, Plaintiff Albert I. Edelman, a stockholder of Phillips, filed the above-captioned Civil Action No. 7899 in the Chancery Court against Phillips and the Individual Phillips Defendants, Mesa, Mesa Partners, Mesa Asset Co. and Mesa Southern Co. (the "*Edelman* Chancery Action"). The *Edelman* Chancery Action was brought individually, derivatively in the right of Phillips and as a class action on behalf of holders of common stock of Phillips.

The complaint in the *Edelman* Chancery Action (as amended on January 14, 1985 and on February 7, 1985) alleged as derivative claims, among other things, that the Individual Phillips Defendants had engaged in conduct designed to "entrench" themselves in office in opposing the attempted takeover of Phillips by Mesa Partners and in agreeing to the Recapitalization and the Phillips/Mesa Agreement, which was alleged to be detrimental to Phillips and its stockholders. The complaint further alleged, among other things, that the Mesa Defendants aided and abetted the alleged violations of fiduciary duties by the Individual Phillips Defendants; that the Mesa Defendants were guilty of misrepresentation or were estopped from entering into the Phillips/Mesa Agreement by reason of the statement in the Schedule 13D filed by Mesa Partners that neither Mesa Partners nor its affiliates "will sell any [common shares] owned by it or them back to the Company except on an equal basis with all other stockholders"; that the standstill provision in the Phillips/Mesa Agreement prohibiting Mesa Partners and affiliates from acquiring any voting securities of Phillips for fifteen years violated Delaware law; and that the Phillips/Mesa Agreement constituted a tortious interference with the proposed Mesa Partners tender offer.

The complaint in the *Edelman* Chancery Action sought, among other things, (a) temporary, preliminary and final injunctive relief against the special meeting of Phillips stockholders scheduled for February 22, 1985 to vote upon the Recapitalization, consummation of the Phillips/Mesa Agreement and the transactions therein referred to, including the Recapitalization, the creation of the EISOP and the proposed sale by Phillips of assets expected to realize \$2 billion, (b) rescission of the Recapitalization and the Phillips/Mesa Agreement and all transactions and actions taken thereunder, (c) if rescission were not granted, an award of unspecified damages, and (d) a declaration that a December 10, 1984 bylaw amendment adopted by Phillips relating to stockholder consents violated Delaware law. The complaint further sought to require Mesa to abide by the above-referenced statement in the Schedule 13D or to require Mesa to account for any profit made in derogation of that statement. Phillips' proxy statements issued in connection with the February 22, 1985 special meeting described Plaintiff's objections to the Recapitalization and the Phillips/Mesa Agreement.

Following extensive discovery, including depositions of two of the Individual Phillips Defendants, of two representatives of Mesa Partners, of representatives of the two investment banking firms

retained by Phillips, and of the Plaintiff and a financial expert retained by the Plaintiff, and extensive briefing, a hearing was had in the Chancery Court on February 8, 1985 upon Plaintiff's application for a preliminary injunction to prevent the February 22, 1984 special meeting of stockholders and the Recapitalization.

In its February 12, 1985 opinion, the Chancery Court denied Plaintiff's motion for a preliminary injunction. The Chancery Court there determined that, on the record then before the Court, Plaintiff had not shown a reasonable probability of success and, among other things: that the Phillips Board of Directors believed that Mesa Partners "did not have the best interests of Phillips and all its shareholders in mind," and that this belief was "clearly justified"; that Phillips' opposition to the Mesa Partners proposal was proper as "an overall effort to resist a potentially destructive tender offer"; that the "basic premise" for the Phillips Board's opposition to the Mesa Partners proposal was that it "would deprive all shareholders of an equal opportunity to realize maximum value for their shares," which Morgan Stanley [one of Phillips' investment bankers] had determined to have a liquidation value of \$60 to \$75 per share"; that the Individual Phillips Defendants' approval of the Recapitalization and "the terms for Mesa's exit" (which included payment to Mesa Partners of \$25 million in expenses) was within the business judgment rule; and that the Recapitalization did not waste corporate assets and was not illegal under Delaware law. The Court also found that Phillips had sufficiently discharged its duty of complete disclosure in connection with the submission of the Recapitalization proposal to the stockholders. The Court concluded that while Plaintiff had raised "serious questions" concerning the Phillips/Mesa Agreement and Recapitalization, such concerns should not prevent submission of the Recapitalization to the Phillips stockholders. The Chancery Court subsequently denied Plaintiff's request for reargument and for certification of an interlocutory appeal to the Delaware Supreme Court. Thereafter, the Delaware Supreme Court also denied Plaintiff's application for certification of an interlocutory appeal.

On February 4, 1985, Phillips received a letter from Icahn which disparaged the Recapitalization and proposed instead a leveraged buyout of all shares of the company for \$55 per share comprised of \$27.50 in cash and \$27.50 in junior debt securities. The Icahn letter indicated that financing for his proposal had not been arranged. The letter further stated that if Phillips did not cooperate with Icahn and his investment banker, Drexel Burnham Lambert Incorporated ("Drexel"), in arranging a leveraged buyout of the company, Icahn would solicit proxies against the Recapitalization and begin a partial tender offer for Phillips common stock at \$55 per share, which if successful would result in Icahn's procuring control of just over 50% of Phillips' common stock.

On February 6, 1985, the Phillips Board rejected the Icahn proposal as inadequate, revised the Recapitalization to increase its attractiveness to the stockholders, and adopted a Note Purchase Rights Plan which the Phillips Board stated was designed to deter two-tier and bust-up takeover attempts at prices that do not reflect a fair value for Phillips.

On February 12, 1985, Icahn commenced a two-tier tender offer for Phillips common stock at \$60 per share, which if successful would have resulted in Icahn's procuring control of just over 50% of the company's common stock. Icahn proposed that after he obtained control of Phillips he would, in a second-tier transaction, acquire the remaining public shares in exchange for debt securities that were supposed to be valued at \$50 per share and that would rank junior to Phillips' pre-existing debt and to the \$4.5 billion in debt securities Icahn would issue to finance his first-tier tender offer. Icahn stated that he did not have at hand the financing necessary for his tender offer, and he expressly made his offer conditional on his obtaining the necessary financing, as well as on rejection by Phillips stockholders of the Recapitalization and elimination of the Note Purchase Rights Plan by judicial decision or redemption by the Phillips Board.

The special meeting convened on February 22, 1985. Plaintiff and his counsel attended the meeting and spoke in opposition to the Recapitalization. When Phillips adjourned the meeting and announced that the polls would remain open, Plaintiff sought injunctive relief against recognition by Phillips of any votes received after 11:30 a.m. on February 22, 1985. On February 27, 1985, the Delaware Chancery Court set forth certain conditions in its order denying Plaintiff's request for a temporary restraining order, including requiring specific identification of any votes submitted to the inspectors of election after the adjournment. On March 3, 1985, Phillips announced that it appeared that the Recapitalization had not obtained the affirmative vote of a majority of the outstanding shares which was required for approval and that, in order to provide the Phillips stockholders a superior economic alternative to the Icahn tender offer, the company would commence an exchange offer (the "Phillips Exchange Offer") to exchange debt securities having an aggregate principal amount of \$62 per share for approximately 50% of its common stock.

Following the announcement of the Phillips Exchange Offer, Phillips entered into an agreement (the "Phillips/Icahn Agreement") with Icahn and related entities pursuant to which, among other things, (a) the Icahn entities agreed that they would not, for a period of eight years (three years in the case of Drexel), acquire any voting securities of or otherwise seek to control the management or policies of Phillips, and (b) Phillips agreed to reimburse the Icahn entities for certified expenses incurred in their takeover attempt up to \$25 million (which amount was subsequently paid by Phillips). Thereafter, Icahn withdrew his tender offer. By the time of the expiration of the Phillips Exchange Offer on March 29, 1985, over 85% of the outstanding shares were tendered, and the 72,580,000 shares tendered for were accepted for exchange by Phillips.

On June 14, 1985, the Plaintiff in the *Edelman* Chancery Action further amended the complaint, alleging that the adoption of the Note Purchase Rights Plan and the March 3, 1985 amendment thereto constituted a breach of fiduciary duty by the Individual Phillips Defendants; that the Note Purchase Rights require Phillips for the ten year term of the Rights to redeem its common stock for \$62 per share (as adjusted) in 15% one-year notes regardless of whether the fair value of the stock is more or less than \$62 per share (as adjusted) at such time or whether 15% is an appropriate interest rate or whether such redemption is an appropriate response to a particular acquisition proposal; that the Note Purchase Rights are not reasonably related to any perceived threat to Phillips; and that the Note Purchase Rights are an illegal attempt to alter the rights of existing Phillips common stock in violation of Delaware law, are redemption rights for common stock which are proscribed by Delaware law and are not authorized by any provision of the Delaware General Corporation Law. The amended complaint also attacked the December 10, 1984 stockholder consent bylaw as violative of Delaware law and as a manipulation of the corporate machinery. The amended complaint sought, as additional relief, an injunction against the invocation of the Note Purchase Rights Plan and the December 10, 1984 consent procedure bylaw and against the issuance of notes under the Note Purchase Rights Plan.

The Note Purchase Rights, which were distributed to holders of Phillips shares on February 18, 1985, become exercisable, subject to certain conditions, when a person or group acquires 30% or more of the shares. When exercisable, a Note Purchase Right entitles the holder to exchange one share for \$19.31 principal amount of one-year 15% Senior Notes of the company (the "Notes"), subject to adjustment, in certain events. (The \$19.31 principal amount represents an adjustment of the original \$62 principal amount contained in the Plan as adopted on February 6, 1985 to reflect the subsequent 3-for-1 split of Phillips common stock and a preferred stock dividend.) Rights held by the person or group acquiring 30% or more of the shares become null and void upon such acquisition. The Note Purchase Rights are redeemable by the company's Board of Directors at \$.08½ per Right prior to a 30% acquisition. Pursuant to an amendment to the Note Purchase Rights Plan adopted on March 3, 1985,

the Rights may not be redeemed by the Board of Directors unless a majority of the Board consists of independent directors elected at an annual meeting of stockholders of the company and in accordance with the procedures contained in the New York Stock Exchange policies and rules (the "NYSE Rules"), or if the Board of Directors of the company is not so constituted, only if the Board of Directors consists of a majority of directors who have been in office for at least 75 days and have been elected in accordance with the procedures contained in the NYSE Rules.

The consent procedure bylaw adopted by the Phillips Board on December 10, 1984 provided among other things, that (a) in the case of any stockholder seeking to have the stockholders authorize or take corporate action by written consent, such stockholder would request the Board of Directors to fix the record date for determining stockholders entitled to express such consent, and the Board would then fix as the record date the 15th day following receipt of the request or any later date specified by the stockholder; (b) the date for determining if action had been consented to by the requisite voting power to authorize or take the action would be the 60th day following the record date; and (c) consents would not become effective until the final termination of proceedings which may have been commenced in the Chancery Court or any other court of competent jurisdiction for an adjudication of any legal issues incident to determining the validity of any of the consents, unless and until such court determined that such proceedings were not being pursued expeditiously and in good faith.

On May 23, 1985, the Plaintiff in the *Edelman* Chancery Action filed a motion for partial summary judgment seeking the invalidation of the Note Purchase Rights Plan and the December 10, 1984 consent procedure bylaw.

Subsequently, on September 9, 1985, the Phillips Board of Directors replaced the consent bylaw adopted on December 10, 1984 with a revised consent procedure bylaw providing generally that (a) the record date for determining stockholders entitled to express consent to corporate action in writing without a meeting shall be fixed by the Board of Directors, which shall do so upon receipt of a request by a stockholder, and (b) in the event of delivery to the company of written consents purporting to represent the requisite voting power to authorize or take corporate action and/or related revocations, nationally recognized independent inspectors of election would be engaged by the Secretary of the company to review the validity of consents and revocations. Plaintiff in the *Edelman* Chancery Action thereafter contended as part of his partial summary judgment motion that the September 9, 1985 revised consent procedure bylaw was also invalid under Delaware law, and has further amended the complaint in the *Edelman* Chancery Action to include such a claim.

The partial summary judgment motion was extensively briefed by Plaintiff and the Phillips Defendants and argument upon the motion was held before the Chancery Court on September 23, 1985. The motion was *sub judice* when the agreement providing for the Settlement was reached.

The Plaintiff in the *Edelman* Chancery Action has also filed a motion for an order certifying the action as a class action on behalf of stockholders of Phillips, and the Phillips Defendants have filed a motion for an order dismissing the action as against them on the grounds that the complaint in that action as amended states derivative claims and that Plaintiff commenced suit without making a demand upon the Board of Directors, and that various claims asserted by Plaintiff fail to state a claim upon which relief may be granted. Both motions have been extensively briefed and were argued on September 23, 1985, with both the Phillips Defendants and the Mesa Defendants opposing the motion for certification of a class in the *Edelman* Chancery Action. The motions were *sub judice* when the agreement providing for the Settlement was reached.

The Lowenschuss Chancery Action

The above-captioned Civil Action No. 7972 in the Chancery Court (the “*Lowenschuss* Chancery Action”) names as defendants the OCC, AMEX and the Phillips Defendants. The plaintiff in the *Lowenschuss* Chancery Action is alleged both to be an owner of Phillips common stock and to have written several hundred put options on shares of Phillips common stock. The complaint in the *Lowenschuss* Chancery Action alleges claims against OCC, AMEX and the Individual Phillips Defendants, on behalf of a class of persons who were Phillips stockholders or who wrote put options on Phillips stock, arising from the determination by defendants OCC and AMEX not to adjust the delivery requirements under the options after the announcement of the Phillips Exchange Offer. The complaint also alleges claims brought derivatively in the right of Phillips against the Individual Phillips Defendants relating to, among other things, Phillips’ opposition to the Mesa Partners takeover attempt, the Phillips/Mesa Agreement, the Recapitalization, Phillips’ opposition to the Icahn takeover attempt, the Note Purchase Rights Plan, the Phillips/Icahn Agreement and the Phillips Exchange Offer, all of which claims are substantially similar to claims asserted in the *Edelman* Chancery Action. When the complaint was filed in the *Lowenschuss* Chancery Action on March 15, 1985, the plaintiff in that action moved for a preliminary injunction against the Phillips Exchange Offer. That motion was extensively briefed and argued before the Chancery Court. On March 27, 1985, the Chancery Court rendered its opinion denying plaintiff’s motion and holding that the Phillips Exchange Offer was authorized by Delaware law and could not be found to be an improper exercise of business judgment by the Phillips Board of Directors. No appeal was sought to be taken from that decision. On June 13, 1985, plaintiff *Lowenschuss* filed a motion for partial summary judgment seeking an adjudication that, by reason of the Phillips Exchange Offer, the Note Purchase Rights have become validly exercisable. On February 20, 1986, the plaintiff in the *Lowenschuss* Chancery Action filed a brief in support of his motion for partial summary judgment. The Phillips Defendants, OCC and AMEX have each filed motions to dismiss the *Lowenschuss* Chancery Action. The plaintiff in the *Lowenschuss* Chancery Action is not a party to the Stipulation or to the Settlement.

Subsequent to the execution of the Stipulation, the plaintiff in the *Lowenschuss* Chancery Action objected to the Settlement on the grounds that the Plaintiff in the *Edelman* Chancery Action is not an adequate representative of the class claims asserted against the Phillips Defendants in the *Lowenschuss* Chancery Action and that the plaintiff in the *Lowenschuss* Chancery Action was improperly excluded from settlement negotiations.

As described below, final approval of the Settlement as provided in the Stipulation will preclude further litigation of the claims asserted against the Phillips Defendants in the *Lowenschuss* Chancery Action that are derivative claims and that are asserted on behalf of the Phillips stockholders (except as to persons in the Class who validly request exclusion therefrom, although such persons validly requesting exclusion will be precluded by the Settlement from asserting the claim raised on the *Lowenschuss* partial summary judgment motion referred to above).

The Consolidated Federal Actions

The above-referenced actions in the Federal Court (the “Consolidated Federal Actions”) include four actions originally filed as separate complaints^{*} at various times on and after the commencement of the *Edelman* Chancery Action on January 2, 1985 (the “*Hudson* Federal Actions”). The separate complaints in the *Hudson* Federal Actions were superseded by a single Class Action and Verified Derivative Supplemental Complaint in Civil Action No. 85-014 MMS (the “*Hudson* Complaint”). The Consolidated Federal Actions also include the *Lawrence* Federal Action and the *Irwin* Federal Action (as defined below), which were consolidated for pretrial purposes with the *Hudson* Federal Actions by Order No. 1 of the Federal Court filed on August 8, 1985. That Order further provided for the appointment of lead counsel and liaison counsel for plaintiffs in the actions consolidated thereby.

The Plaintiffs in the *Hudson* Federal Actions, stockholders of Phillips, brought the *Hudson* Federal Actions on behalf of themselves and on behalf of Phillips stockholders similarly situated as a class action and/or derivatively in the right of Phillips. Many of the claims in the *Hudson* Federal Actions were in substantial part similar to those alleged in the prior-filed *Edelman* Chancery Action and also included, among other things, claims based on violations of the federal securities laws.

The *Hudson* Complaint alleges, among other things, that the Mesa Defendants violated the federal securities laws in that representations allegedly made by the Mesa Defendants in the Schedule 13D that Mesa Partners would not sell its shares of Phillips common stock back to Phillips except on an equal basis with all other shareholders were false and misleading and that there was an alleged failure to disclose that Mesa Partners intended to enter into and had entered into negotiations with Phillips with a view to selling its Phillips shares to Phillips at a premium price not available to other stockholders; that the Mesa Defendants are liable to Plaintiffs and members of the class under the doctrine of promissory estoppel and as a contractual matter by reason of the alleged commitment by the Mesa Defendants that they would not sell back the Phillips shares held by them except on an equal basis with all other stockholders; that the payment to Icahn of \$25,000,000 in reimbursement of expenses violated Delaware law; that the statement in Icahn’s February 4, 1984 letter to Phillips (which letter was subsequently filed with the SEC) that Icahn would not accept an offer to repurchase his Phillips shares unless the same offer was made to all Phillips stockholders was allegedly false and misleading; that the Phillips Defendants wrongfully interfered with the business advantage repre-

^{*} *Florence Hudson v. Phillips Petroleum Company, Mesa Petroleum Co., Mesa Partners, Carol C. Laise, David B. Meeker, C. J. Silas, R.G. Wallace, W. Clark Wescoe, Dolores D. Wharton, Francis M. Wheat, George B. Beitzel, Michael N. Chetkovich, Glenn A. Cox, William C. Douce, James B. Edwards, E. Douglas Kenna, C.M. Kittrell, Melvin R. Laird, and Robert F. Froehlke*, Civil Action No. 85-014 MMS (D. Del., filed January 8, 1985); *Harry W. Voegel, S. Paul Posner & Co., a partnership, Ominsky, Joseph & Welsh, P.C. Defined Benefit Plan U/A dated DDT July 1, 1976, Albert Ominsky Trustee, Barnett Stepak, Initio, Inc., Alfred D. Whitman, Connecticut Medical Laboratory Inc., Murray Bell, Pierre Haber, and Leonard Brauer v. Phillips Petroleum Company, William C. Douce, C. J. Silas, Glenn A. Cox, C.M. Kittrell, R.G. Wallace, George B. Beitzel, Michael N. Chetkovich, James B. Edwards, Robert F. Froehlke, E. Douglas Kenna, Melvin R. Laird, Carol C. Laise, David B. Meeker, W. Clark Wescoe, Dolores D. Wharton, Francis M. Wheat, Mesa Petroleum Co., Mesa Partners, a Texas partnership, T. Boone Pickens, Jr., Phillips Petroleum Company, William C. Douce, C. J. Silas, Glenn A. Cox, C.M. Kittrell, R.G. Wallace, George B. Beitzel, Michael N. Chetkovich, James B. Edwards, Robert F. Froehlke, E. Douglas Kenna, Melvin R. Laird, Carol C. Laise, David B. Meeker, C. J. Silas, R.G. Wallace, W. Clark Wescoe, Dolores Wharton, Francis M. Wheat, and Phillips Petroleum Company, a Delaware Corporation, Civil Action No. 85-401 MMS (filed in the United States District Court for the Central District of California on January 2, 1985 and subsequently transferred to the District of Delaware); and *Jerry C. Cohen v. Mesa Petroleum Co., Mesa Partners, Mesa Asset Co., Cy-7, Inc. and Jack-7 Inc.*, Civil Action No. 85-537 MMS (filed on January 9, 1985 in the United States District Court for the Northern District of Texas and subsequently transferred to the District of Delaware).*

sented by the Mesa and Icahn takeover attempts; that the Individual Phillips Defendants breached their fiduciary duties in responding to the various proposals made by the Mesa Defendants and the Icahn Defendants, including by entering into the Phillips/Mesa Agreement and the Phillips/Icahn Agreement and adopting the Note Purchase Rights Plan; and that the Mesa Defendants and the Icahn Defendants induced such breaches of fiduciary duty. The *Hudson* Complaint seeks, among other things, to require that Mesa Partners disgorge all profits received on the sale of its Phillips shares to Phillips; to require that the Icahn Defendants disgorge all reimbursement of expenses received from Phillips; to declare the Note Purchase Rights Plan to be unlawful; and to award damages, including trebled and punitive damages, for the acts and transactions complained of.

The Phillips Defendants previously filed motions to dismiss the *Hudson* Federal Actions on the grounds, *inter alia*, of the Plaintiffs' failure to make a demand upon the Phillips Board of Directors prior to commencing suit and for failure to state a claim upon which relief may be granted against the Phillips Defendants. The Mesa Defendants have filed an answer to the *Hudson* Complaint denying the material allegations thereof and asserting affirmative defenses. The Icahn Defendants have filed motions to dismiss the *Hudson* Complaint. Plaintiffs in the *Hudson* Federal Actions have filed a motion seeking to certify a class of Phillips stockholders. All of such motions were pending when the agreement providing for the Settlement was reached.

Also included among the Consolidated Federal Actions, as referred to above, is an action entitled *Michael K. Irwin, Walter Ryan, Dennis Ryan, Joseph Feitler, and Eleanor G. Feitler, derivatively on behalf of Phillips Petroleum Company v. William C. Douce, Glenn A. Cox, Michael N. Chetkovich, C.M. Kittrell, Carol C. Laise, C.J. Silas, R.G. Wallace, W. Clark Wescoe, Dolores D. Wharton, Francis M. Wheat, George B. Beitzel, James B. Edwards, Robert F. Froehlke, E. Douglas Kenna, Melvin Laird, David B. Meeker, Carl C. Icahn, Icahn Group Inc., Unicorn Associates Corporation, Longview Investors Limited Partnership, Ocelot Associates Corporation, Heron Investors Plan Inc., Icahn Acquisition Corp., ACF Industries, Incorporated, Icahn Holding Corporation, Icahn Capital Corporation, and Phillips Petroleum Company, a Delaware Corporation*, Civil Action No. 85-281 MMS (D. Del., filed May 13, 1985) (the "*Irwin Federal Action*"). The *Irwin* Federal Action alleges claims under state law brought derivatively in the right of Phillips against the Individual Phillips Defendants and the Icahn Defendants principally based upon the Phillips Board's approving reimbursement of \$25 million of expenses incurred by the Icahn entities in their takeover attempt, approving "golden parachute" agreements with four Phillips officers and approving other unspecified fees and costs, and upon the dismissal by certain of the Icahn Defendants, following the Phillips/Icahn Agreement, of derivative claims they had brought in the right of Phillips against the Individual Phillips Defendants. The Phillips Defendants and the Icahn Defendants have each filed motions to dismiss the *Irwin* Federal Action.

The plaintiffs in the *Irwin* Federal Action initially objected to the Federal Court's giving preliminary approval to the Settlement while a decision was pending in the Delaware Supreme Court in another case unrelated to the Actions but which concerned issues that the plaintiffs in the *Irwin* Federal Action believed were analagous to issues in the *Irwin* Federal Action, and until additional discovery could be taken. After the Delaware Supreme Court issued its opinion in that unrelated case, the plaintiffs in the *Irwin* Federal Action withdrew their objection to the Federal Court giving the Settlement its preliminary approval, and have joined in the Settlement.

The Lawrence Federal Action

There is also pending in the Federal Court, as referred to above, another action included among the Consolidated Federal Actions entitled *John S. Lawrence, on behalf of himself and all others similarly situated v. T. Boone Pickens, Jr., Mesa Partners, Mesa Petroleum Company, Phillips Petroleum Company, William C. Douce, C.J. Silas, Glen A. Cox and R.G. Wallace*, Civil Action No. 85-447 MMS (the

"*Lawrence Federal Action*"). The *Lawrence Federal Action*, originally filed in the United States District Court for the Southern District of New York on March 13, 1985 and ordered transferred to the Federal Court over plaintiff Lawrence's opposition, alleges claims under the federal securities laws and state law on behalf of a class of persons who purchased Phillips common shares on December 20 and 21, 1984, against certain of the Mesa Defendants, Phillips and certain of the Individual Phillips Defendants principally based on an alleged failure to disclose an intent to negotiate and the existence of negotiations preceding the Phillips/Mesa Agreement of December 23, 1984.

The plaintiff in the *Lawrence Federal Action* is not a party to the Stipulation or to the Settlement. The plaintiff in the *Lawrence Federal Action* objected to the Federal Court's giving preliminary approval to the Settlement on the ground that dismissal with prejudice pursuant to the Settlement of the Class claims asserted against the Phillips Defendants in the Federal Actions, as described below, would also preclude further litigation of the class claims asserted in the *Lawrence Federal Action* against the Phillips Defendants.

Prior to the entry of the Stipulation, the plaintiff in the *Lawrence Federal Action* had moved for an order permitting him to voluntarily dismiss the *Lawrence Federal Action*. On February 25, 1986, the Federal Court granted Lawrence's motion for voluntary dismissal on the condition that he not file in any court in the United States a duplicative class action based on the Phillips-Mesa and Phillips-Icahn takeover controversy.

As described below, final approval of the Settlement will preclude further litigation (in any court) of the class claims asserted in the *Lawrence Federal Action* against the Phillips Defendants.

Coordinated Discovery in The Actions

Discovery by the Plaintiffs has proceeded in accordance with Pretrial Order No. 7 of the Federal Court, dated August 27, 1985, which provided for the coordination of all discovery in the *Edelman* Chancery Action and the Consolidated Federal Actions.

The discovery has included the examination of documents produced by the defendants, and extensive depositions (in addition to those taken in the *Edelman* Chancery Action in preparation for the preliminary injunction motion therein against the February 22, 1985 Special Meeting of stockholders and the Recapitalization) of eleven of the Individual Phillips Defendants and of two of the individual Mesa Defendants.

Consideration of Settlement

Counsel for Plaintiffs in the *Edelman* Chancery Action and *Hudson* Federal Actions have made a thorough investigation into the allegations giving rise to the claims against the Phillips Defendants in the Actions. Plaintiffs' attorneys have reviewed the extensive discovery into such allegations and have conducted studies and analyses of the law relating to such allegations.

Having made such investigation, and in light of the facts developed in the discovery and considering the applicable law, Plaintiffs in the *Edelman* Chancery Action and the *Hudson* Federal Actions and their attorneys have concluded that: (i) actions taken by the Phillips Defendants and other events (including the nonapproval by the stockholders of the Recapitalization and the making of the Phillips Exchange Offer) have largely mooted the claims alleged against the Recapitalization and other provisions of the Phillips/Mesa Agreement; (ii) the Phillips Exchange Offer produced a realizable cash value for the benefit of the Phillips stockholders; and (iii) under all the circumstances, including the attendant risks of litigation and the benefits Plaintiffs believe their lawsuits have conferred and the Settlement will confer on Phillips and its stockholders, it is desirable and in the best interests of Phillips and its present stockholders and the Class to settle the *Edelman* Chancery Action and the *Hudson* Federal Actions in the manner and upon the terms and conditions hereinafter set

forth. Plaintiffs' attorneys have conducted arm's-length negotiations with representatives of the Phillips Defendants with a view to settling the issues in dispute and achieving the best means for effectuating relief consistent with the interests of Phillips' stockholders and members of the Class. The Settlement provided for in the Stipulation and described herein is the result of such negotiations and the Plaintiffs have concluded that such terms and conditions are fair, reasonable and beneficial to and in the best interests of Plaintiffs, Phillips and its present stockholders and the members of the Class.

Phillips and the Individual Phillips Defendants firmly believe that they at all times have acted in the best interests of Phillips and of its stockholders, and that their actions in defeating the inadequate Mesa and Icahn proposals produced realizable values for the Phillips stockholders in the short-term which exceeded the realizable values proposed to be offered by Mesa and Icahn and which preserved the long-term values of Phillips for the benefit of its stockholders. The Phillips Defendants have vigorously denied and contested, and continue vigorously to deny and contest, all claims of illegality and violations of law asserted in the Actions, and continue to maintain that all of their actions have been entirely proper and valid under Delaware law, including with respect to the Note Purchase Rights Plan and the consent procedure bylaw of September 9, 1985. The Phillips Defendants are agreeing to the Settlement solely because the Settlement would benefit Phillips by eliminating the substantial expense of continued litigation and the concomitant distraction of resources and effort from the business of Phillips that continued protracted litigation would inevitably engender, and by providing for the implementation of the provisions of the Settlement, including the Preferred Share Purchase Rights Plan and the Revised Consent Procedure Bylaw (as defined below), which the current Phillips Board of Directors believes to be beneficial to Phillips and its stockholders.

CLASS AND DERIVATIVE ACTION DETERMINATION

The Parties to the Stipulation have agreed and the respective Courts have ordered that, for purposes of the Settlement only, the *Edelman* Chancery Action and the *Hudson* Federal Actions shall be maintained and proceed as derivative actions in the right of Phillips pursuant to Rule 23.1 of the Rules of the Chancery Court and Rule 23.1 of the Federal Rules of Civil Procedure, and as class actions pursuant to Rule 23(b)(3) of the Rules of the Chancery Court and Rule 23(b)(3) of the Federal Rules of Civil Procedure on behalf of the Class consisting of all record or beneficial holders of shares of common stock of Phillips as of December 4, 1984 and their successors in interest or transferees, immediate and remote, through the close of business on March 29, 1985, the date of the expiration of the Phillips Exchange Offer, other than the defendants in the Actions. If you owned shares of Phillips common stock on December 4, 1984, and/or thereafter purchased or acquired shares of Phillips common stock at any time prior to the close of business on March 29, 1985, you are a member of the Class.

The parties to the Stipulation have also agreed and the respective Courts have ordered that, for purposes of the Settlement only, the named Plaintiffs in the *Edelman* Chancery Action and the *Hudson* Federal Actions shall be the derivative and Class representative plaintiffs, and William Prickett, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, 1310 King Street, Wilmington, Delaware 19899, and Joseph A. Rosenthal, Esquire, of Morris & Rosenthal, P.A., One Customs House Square, P.O. Box 1070, Wilmington, Delaware 19899, and Stephen D. Oestreich, Esquire, of Wolf Popper Ross Wolf & Jones, 845 Third Avenue, New York, New York 10022, shall be derivative and Class counsel in the *Edelman* Chancery Action and the *Hudson* Federal Actions, respectively.

THE SETTLEMENT TERMS

The principal terms, conditions and other matters which are part of the Stipulation and the Settlement are summarized in this and succeeding sections below. This summary should be read in

conjunction with, and is qualified in its entirety by reference to, the text of the Stipulation, a copy of which is on file with each of the Courts in the Actions and which may be examined at each of those Courts as described below. Reference is also made to the Orders entered by the Chancery Court and the Federal Court, respectively, relating to the Settlement, which are referred to herein.

The Settlement provides for the full settlement, compromise, release and discharge of all claims that are or could have been asserted in the Actions by any Phillips stockholder or any member of the Class, or any of their officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors or assigns, or by Phillips, whether individual, class, derivative, representative, legal, equitable or of any other type, or in any other capacity, in connection with or that arise now or hereafter out of any matters, transactions or occurrences referred to in the Actions or the Stipulation (except for compliance with the Settlement) (a) against any of the Phillips Defendants, or against any of their present or former officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors or assigns (including without limitation (i) the claims alleged against the Phillips Defendants in the *Lowenschuss* Chancery Action derivatively or on behalf of Phillips stockholders, (ii) the claims alleged against any of the Phillips Defendants in the *Lawrence* Federal Action and (iii) the claims alleged derivatively against any of the Phillips Defendants in the *Irwin* Federal Action), whether or not presently known; and (b) against any other defendant in the Actions or any other person arising from an allegation that such other defendant or person aided and abetted, conspired with, induced or otherwise acted in concert with any of the Phillips Defendants with respect to any of the conduct of the Phillips Defendants as alleged in the Actions or that are or could have been asserted derivatively in the right of Phillips against such other defendants or person (all of the above described and identified claims being hereinafter collectively referred to as the "Settled Claims").

Adoption of Preferred Share Purchase Rights Plan; Elimination of Note Purchase Rights Plan

The Settlement provides that Phillips, by action of its Board of Directors, shall adopt and enter into a Rights Agreement and in connection therewith authorize and declare a dividend of one Preferred Share Purchase Right for each common share of Phillips as therein referred to (the "Preferred Share Purchase Rights Plan"). The Preferred Share Purchase Rights Plan is of the general type approved by the Delaware Supreme Court in *Moran v. Household International, Inc.*, Del. Supr., No. 37, 1985 (Nov. 19, 1985), as authorized under Delaware law, protected by the business judgment rule and reasonable in relation to the threat posed by coercive acquisition techniques. The Preferred Share Purchase Rights Plan, which the Phillips Defendants and the Plaintiffs agree provides greater benefits to Phillips and its stockholders than the current Note Purchase Rights Plan, shall be substituted for the Note Purchase Rights Plan, which shall be eliminated, as of the time approval of the Settlement becomes final without the burden and expense to Phillips of redeeming the Note Purchase Rights. Copies of the Rights Agreement are available upon request of persons receiving this Notice from counsel to the plaintiff in the *Edelman* Chancery Action (William Prickett, Esquire, Prickett, Jones, Elliott, Kristol & Schnee, 1310 King Street, Wilmington, Delaware 19899) and from liaison counsel for the plaintiffs in the Consolidated Federal Actions (Joseph A. Rosenthal, Esquire, Morris & Rosenthal, P.A., One Custom House Square, P.O. Box 1070, Wilmington, Delaware 19899). The principal terms of the Preferred Share Purchase Rights are as follows:

Term: 7 years.

Right: Each Preferred Share Purchase Right consists of a Right to buy one one-hundredth of a share of Phillips Series A Junior Participating Preferred Stock.

Exercise price: The exercise price of each Right is \$35 per one one-hundredth of a share. The exercise price is subject to certain antidilution adjustments.

Rights detach and become exercisable: Prior to such time as a person or group acquires beneficial ownership of 20% or more of Phillips' common stock or announces its intention to commence a tender or exchange offer for 30% or more of the company's common stock, the Rights would be nonexercisable and would not be transferable apart from the company's common stock. As soon as practicable after such time, separate Rights certificates would be issued and the Rights would become exercisable and transferable.

Protection against squeezeout: In the event an acquiring person were to acquire control of Phillips and then were to merge or otherwise combine with the company, each Right then outstanding would become a right to buy that number of shares of common stock of the acquiring company which at the time of the merger would have a market value of two times the exercise price of the Right.

Protection against self-dealing: If a 20% or more shareholder were to effect an acquisition of Phillips by means of a reverse merger in which Phillips and its stock survive, or were to engage in certain self-dealing transactions with Phillips (such as sales of assets to the company or obtaining certain financial benefits from the company), each Right not owned by such shareholder would become exercisable for that number of shares of the company's common stock which at the time of such transaction would have a market value of two times the exercise price of the Right.

Redemption: The Rights would be redeemable by the Phillips Board of Directors at a price of \$.08½ per Right (the current redemption price of the Note Purchase Rights) at any time prior to the acquisition by a person or group of beneficial ownership of 20% or more of the company's common stock. The ability to redeem the Rights could be exercised by the Board if it consists of a majority of "Independent Directors" (as defined in the Rights Agreement generally to mean the current outside directors of Phillips or their nominees) or, if not, only by a Board consisting of a majority of directors elected at an annual meeting of stockholders or by written consents in accordance with procedures contained in the NYSE Rules and the bylaws of Phillips relating to annual meetings and written consents (including the bylaw relating to consent procedure referred to below). In addition, at any time after ten days following the acquisition by any person or group of beneficial ownership of 20% or more of the company's common stock and before such person or group merges or otherwise combines with or engages in certain self-dealing transactions with Phillips, or before Phillips consolidates with, merges with or sells or transfers more than 50% of its assets or earning power to another party, the Board may redeem the Rights in connection with a merger or business combination with a party other than such 20% or more owner of the company's common stock if the Board consists of a majority of "Independent Directors" elected at an annual meeting of stockholders in accordance with the NYSE Rules and if a majority of the "Independent Directors" votes to redeem the Rights.

Voting: The Rights would not have any voting rights.

Following consummation of the Settlement, Phillips may not amend the Rights Agreement to increase the term of the Preferred Share Purchase Rights Plan beyond the seven year term provided for therein or to alter the section of the Rights Agreement relating to redemption of the Preferred Share Purchase Rights (except with respect to the period of time during which the Rights may be redeemed) and Phillips will not redeem the Preferred Share Purchase Rights out of funds that otherwise would have been paid to the stockholders as a dividend on the common stock.

Adoption of Revised Consent Procedure Bylaw

The Settlement provides that Phillips, by action of its Board of Directors, shall adopt a consent procedure bylaw (the "Revised Consent Procedure Bylaw"), in the form annexed as Appendix I hereto, in place of the current consent procedure bylaw adopted on September 9, 1985, to become effective as of the time approval of the Settlement becomes final, at which time the consent procedure bylaw adopted on September 9, 1985 shall be deemed repealed.

Agreed Payment to the Class

Under the Settlement, Phillips agrees to pay a sum of money to members of the Class in the event that the Class (or any sub-class thereof) obtains a recovery, by judgment or settlement, in the Actions against the Mesa Defendants and/or the Icahn Defendants, on any claims against such parties based on the current subject matter of the Actions (the "Agreed Payment to the Class") as follows: Phillips shall pay an amount equal to 20% of the aggregate amount of any such judgments or settlements up to an aggregate of \$20 million (*i.e.*, Phillips' payment shall be up to a maximum of \$4 million), and a further amount equal to 8% of the aggregate amount of any such judgments or settlements in excess of \$20 million but not to exceed an additional \$25 million in the aggregate (*i.e.*, Phillips' payment shall be up to another \$2 million). Accordingly, the maximum Phillips may be required to pay to the members of the Class under such provision in any circumstances is \$6 million, regardless of how the amount may be apportioned by the Courts among different claims, elements of damages or sub-classes or whether it is an additional payment to the Class.

The obligations incurred by the Phillips Defendants pursuant to the Stipulation are in full settlement, compromise, release and discharge of the Settled Claims, and the Phillips Defendants or any of them will have no further or other liability or obligation to any person with respect to the Settled Claims except as expressly provided for in the Stipulation. None of the Mesa Defendants or the Icahn Defendants have asserted any claims over (in the nature of indemnity, contribution or otherwise, however denominated) against the Phillips Defendants in or outside the Actions. In addition, the parties to the Settlement do not believe that any claims in the Actions against the Mesa Defendants or the Icahn Defendants could give rise to any such claims over. Nonetheless, in order further to limit the liability on the part of the Phillips Defendants to that expressly provided for in the Settlement and in the Stipulation, the Stipulation also contains a provision designed to protect the Phillips Defendants from any liability upon any such claim over by any party or other person and which claim over arises by reason of any claim relating to the subject matter of the Actions made by or on behalf of any of the Plaintiffs, the Class or members of the Class. Such provision provides for the indemnification of the Phillips Defendants to be effected by each of the Plaintiffs, the Class and the members of the Class reducing or crediting against any judgment he, it or they may obtain (including without limitation any judgment obtained on behalf of the Class or any sub-class thereof by a representative plaintiff who is excluded from the Class pursuant to the provisions of the Stipulation, which are described below under "REQUESTS FOR EXCLUSION FROM THE CLASS") against any person (including without limitation any other defendant in the Actions) the full amount of any judgment entered against any of the Phillips Defendants upon any such claim over, and further agreeing to reduce, to the extent of any pro rata share of the Phillips Defendants (if any), the damages recoverable by Plaintiffs, the Class and the members of the Class (including without limitation any damages obtained on behalf of the Class or any sub-class by a representative plaintiff who is excluded from the Class pursuant to the provisions of the Stipulation, which are described below under "REQUESTS FOR EXCLUSION FROM THE CLASS") against any person other than the Phillips Defendants in accordance with (without limitation) the provisions of 10 *Del. C.* § 6304(b). Under no

circumstances shall any Plaintiff, the Class or any member of the Class have any indemnity obligation in an amount greater than the amount of the recovery by judgment or judgments which he, it or they may obtain.

ORDERS AND FINAL JUDGMENTS

As described below under “THE HEARINGS”, the Chancery Court and the Federal Court have scheduled hearings to finally consider the fairness, reasonableness and adequacy of the proposed Settlement. At the Settlement hearings, the parties to the Settlement have agreed jointly to request the Chancery Court and the Federal Court to enter, conditional upon entry of an Order and Final Judgment in the Actions in the other Court, an Order and Final Judgment:

(i) finally approving the Settlement, including the substitution of the Preferred Share Purchase Rights Plan for the Note Purchase Rights Plan, the Revised Consent Procedure Bylaw, and the Agreed Payment to the Class, as fair, reasonable and adequate and directing consummation of the Settlement in accordance with its terms and provisions;

(ii) dismissing the *Edelman* Chancery Action, the *Lowenschuss* Chancery Action, the *Hudson* Federal Actions, the *Lawrence* Federal Action and the *Irwin* Federal Action on the merits as to the Phillips Defendants and any of their present or former officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors or assigns, with prejudice against the plaintiffs, the members of the Class, and any of their officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors or assigns, without costs except as hereinafter provided, such dismissal to be subject to compliance by the parties to the Settlement with the terms and conditions of the Settlement and any Order of the Chancery Court or the Federal Court with reference to the Settlement, and releasing and discharging the Phillips Defendants (and any of their present or former officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors or assigns) and the other defendants and any other person from all of the Settled Claims;

(iii) permanently barring and enjoining the plaintiffs and all members of the Class, their officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors and assigns, either directly, representatively, derivatively or in any other capacity, from instituting or prosecuting any other action asserting any of the Settled Claims;

(iv) reserving jurisdiction over all matters related to the administration and consummation of the terms of this Settlement and over the plaintiffs and the members of the Class in connection therewith;

(v) making an express determination that there is no just reason for delay and expressly directing that the order is a final judgment upon fewer than all of the claims or parties pursuant to Chancery Court Rule 54(b) and Fed.R.Civ.P. 54(b); and

(vi) making an express determination that the provisions for the indemnification of the Phillips Defendants set forth in the Stipulation (which are described above under “AGREED PAYMENT TO THE CLASS”) shall be binding upon any person who is certified by the Chancery Court, the Federal Court or any other court as a class representative for a class consisting of persons who are members of the Class or any sub-class thereof.

The Stipulation further provides that, effective upon the final approval of the Settlement, and except with respect to the express obligations set forth therein, Plaintiffs, the Class and the members of the Class release and discharge each of the Phillips Defendants from all claims relating to the Settled Claims. In addition, the Stipulation provides for Phillips to deliver a release of claims to each of the Individual Phillips Defendants following final approval of the Settlement.

If the terms of this Settlement shall be finally approved by the Chancery Court and the Federal Court, Plaintiffs' attorneys will apply to the respective Courts for an award of attorneys' fees with respect to the settlement of the derivative claims in an aggregate amount not to exceed \$1.5 million and expenses actually incurred in an aggregate amount not to exceed \$200,000. Such applications may be presented, at the option of Plaintiffs' attorneys, at or subsequent to the Settlement hearings in the respective Courts. The Phillips Defendants have agreed to pay or cause to be paid such fees and expenses within these limits as may be awarded by the respective Courts to Plaintiffs' counsel. Any award of fees or disbursements by the Courts pursuant hereto shall be conditional upon the final approval of the Settlement and entry of the Order and Final Judgment by the Chancery Court and the Federal Court. The Phillips Defendants will not oppose such applications for attorneys' fees and expenses; provided, however, that no other application be made to the Federal Court or the Chancery Court by any member of the Class for an award of additional attorneys' fees and/or expenses with regard to the Settlement or the Settled Claims. Any attorneys' fees and expenses awarded by the Courts to the plaintiffs' attorneys shall not be payable unless and until the dismissals with prejudice of the *Edelman* and *Lowenschuss* Chancery Actions and the Consolidated Federal Actions shall be finally affirmed on appeal or, by the lapse of time or otherwise, shall not be subject to appeal.

It is an express condition of the Settlement that the Settlement be finally approved by both the Chancery Court and the Federal Court, and that the *Edelman* and *Lowenschuss* Chancery Actions and the Consolidated Federal Actions all be dismissed with prejudice as to the Phillips Defendants by such Courts pursuant to the Orders and Final Judgments described in the Stipulation. Unless final approval by both Courts is granted, the Settlement may be terminated by the parties to the Settlement. In addition, the Stipulation provides that the Phillips Defendants have the option to withdraw from the Settlement if certain events occur, including (i) the Orders and Final Judgments are not entered by August 1, 1986, (ii) prior to the Settlement hearings, additional claims not presently pending are asserted against any of the Phillips Defendants in the Actions or in any other actions which relate to the subject matter of the Actions, (iii) attorneys' fees and disbursements in excess of \$1.7 million in the aggregate are awarded to Plaintiffs' counsel and any other counsel appearing for any member of the Class in the Actions, (iv) there is excluded from the Class pursuant to the provisions described below more than an agreed upon number of shares of Phillips common stock (which agreed upon number has been filed under seal with the Chancery Court and the Federal Court), or (v) at any time prior to final approval of the Settlement including any appeals, any other action not presently pending asserting claims that include Settled Claims is commenced and permitted to proceed.

Except as expressly provided for in the Stipulation, nothing in the Stipulation or the Settlement is intended to restrict the powers, abilities, rights or discretion of Phillips and its Board of Directors as to any of the subject matters of the Actions or the Settlement including (without limitation) to submit any proposal or proposals deemed appropriate to the Phillips stockholders on any subject, including (without limitation) on the subject of written consents, to redeem the Preferred Share Purchase Rights and/or to adopt any type of rights plan, including (without limitation) a note purchase rights plan, or similar plan, and Phillips and its Board of Directors expressly reserve the right to take any such action. Nothing in the Stipulation or the Settlement is intended to preclude Phillips' stockholders from objecting to or challenging any such future action.

Except as expressly provided in the Stipulation, the Settlement does not include the settlement of claims on behalf of members of the Class against the Mesa Defendants, the Icahn Defendants, OCC and AMEX. Final approval of the Settlement thus would not result in discontinuation of the *Edelman* or the *Lowenschuss* Chancery Actions or of the *Hudson* Federal Actions or the *Lawrence* Federal Action. Final approval of the Settlement would, however, result in discontinuation of the *Irwin* Federal Action, as it is brought only as a derivative action. The Plaintiffs in the *Hudson* Federal Actions have expressed an intention to seek to amend their complaint to add class claims against the Icahn Defendants alleging additional violations of the federal securities laws and state law based on the statement in Icahn's February 4, 1985 letter that Icahn would not accept an offer to repurchase his Phillips shares unless the same offer was made to all Phillips stockholders and the subsequent payment to Icahn of \$25,000,000 in reimbursement of expenses under the Phillips/Icahn Agreement.

The terms of the Settlement may be amended or any of its provisions waived by a writing executed by the parties to the Settlement. In addition, the Phillips Defendants may waive, in whole or in part, their right to withdraw from the Settlement upon the occurrence of certain specified events described above. Also, pursuant to the Chancery Court Order of March 5, 1986 and the Federal Court Order of March 17, 1986, both Courts reserve the power to finally approve the Settlement with such modifications as may be agreeable to the parties to the Settlement, without further notice to the stockholders of Phillips or the Class.

THE HEARINGS

Pursuant to the March 5 and 17, 1986 Orders of the Chancery Court, a hearing (the "Chancery Settlement Hearing") will be held on May 29, 1986, at 11:00 a.m. (EDT) before the Honorable Joseph T. Walsh, in the Public Building, 11th and King Streets, Wilmington, Delaware 19801, for the purpose of finally determining whether the proposed Settlement is fair, reasonable and adequate and whether it should be approved by the Chancery Court and the *Edelman* and *Lowenschuss* Chancery Actions dismissed on the merits with prejudice as to the Phillips Defendants as provided for in the Stipulation and described above. The Chancery Settlement Hearing may be adjourned from time to time by the Chancery Court at the Chancery Settlement Hearing or at any adjourned session thereof without further notice.

Pursuant to the March 17, 1986 Order of the Federal Court, a hearing (the "Federal Settlement Hearing") will be held on June 2, 1986 at 11:00 a.m. (EDT) before the Honorable Murray M. Schwartz, Chief Judge, in the J. Caleb Boggs Building, 844 King Street, Wilmington, Delaware 19801, for the purpose of finally determining whether the proposed Settlement is fair, reasonable and adequate and whether it should be approved by the Federal Court and the Consolidated Federal Actions dismissed on the merits with prejudice as to the Phillips Defendants as provided for in the Stipulation and described above. The Federal Settlement Hearing may be adjourned from time to time by the Federal Court at the Federal Settlement Hearing or at any adjourned session thereof without further notice.

In addition, the Settlement Hearings may also concern an application for attorneys' fees and expenses by Plaintiffs' attorneys, if Plaintiffs' attorneys elect to present such application at such time.

At the Settlement Hearings, (a) any member of the Class who does not duly request exclusion as described below under "REQUESTS FOR EXCLUSION FROM THE CLASS" and who objects to the Settlement or the Final Judgments to be entered with respect to the settlement of individual or class claims, or who wishes to be heard on any other matter, and (b) any person currently a stockholder of Phillips who objects to the Settlement or the Final Judgments to be entered with respect to the settlement of the derivative claims, or who wishes to be heard on any other matter, may appear in person or by his attorneys at the Settlement Hearings and present any evidence or argument that may be proper and relevant; provided that no such person shall be heard, and no papers, briefs, pleadings,

or other documents submitted by any such person shall be received and considered by either of the respective Courts (unless such Court in its discretion shall otherwise elect upon application of any such person and for good cause shown), unless not later than ten (10) days prior to the Settlement Hearing or Hearings at which such person desires to be heard — *i.e.*, May 19, 1986 with respect to the May 29, 1986 Chancery Settlement Hearing and May 23, 1986 with respect to the June 2, 1986 Federal Settlement Hearing — (i) a notice of intention to appear, (ii) a statement of such person's objections to any matter before the Court and (iii) the grounds therefor or any reasons for such person desiring to appear and to be heard, as well as all documents or writings which such person desires the Court to consider, shall be filed by such person with (a) in the case of the Chancery Court, the Register in Chancery, Public Building, 11th and King Streets, Wilmington, Delaware 19801, and (b) in the case of the Federal Court, the Clerk of the District Court, J. Caleb Boggs Building, 844 King Street, Wilmington, Delaware 19801, and on or before such filing, shall be served upon the following counsel of record: William Prickett, Esquire, of Prickett, Jones, Elliott, Kristol & Schnee, 1310 King Street, Wilmington, Delaware 19899 (with respect to the Chancery Settlement Hearing only); Joseph A. Rosenthal, Esquire, Morris & Rosenthal, P.A., One Customs House Square, P.O. Box 1070, Wilmington, Delaware 19899 (with respect to the Federal Settlement Hearing only); Stephen D. Oestreich, Esquire, Wolf Popper Ross Wolf & Jones, 845 Third Avenue, New York, New York 10022 (with respect to the Federal Settlement Hearing only); Bruce M. Stargatt, Esquire, Young, Conaway, Stargatt & Taylor, Rodney Square North, Eleventh Floor, P.O. Box 391, Wilmington, Delaware 19899; and Martin P. Tully, Esquire, Morris, Nichols, Arsht & Tunnell, Twelfth and Market Streets, P.O. Box 1347, Wilmington, Delaware 19899. In the respective Orders of March 5, 1986 and March 17, 1986, the Chancery Court and the Federal Court have each ordered that (unless such Court shall otherwise direct), no stockholder of Phillips and no member of the Class or other person shall be entitled to object to the Settlement, including the substitution of the Preferred Share Purchase Rights Plan for the Note Purchase Rights Plan, the Revised Consent Procedure Bylaw and the Agreed Payment to the Class, or to the Judgments to be entered herein, or otherwise to be heard, except by serving and filing written objections as described above, and that any person who fails to object in the manner prescribed above shall be deemed to have waived such objection and shall be forever barred from raising such objection in this or any other action or proceeding.

In the respective Orders of March 5, 1986 and March 17, 1986, the Chancery Court and the Federal Court preliminarily approved the Settlement as being within the range of reasonableness and meriting submission to the present Phillips stockholders and the members of the Class for their consideration. This preliminary approval is not final or conclusive and neither Court will finally approve the Settlement until the members of the Class and the present stockholders of Phillips are granted an opportunity to be heard by the Courts on the reasonableness and adequacy of the Settlement.

In the respective Orders of March 5, 1986 and March 17, 1986, the Chancery Court and the Federal Court have each further ordered that pending final determination of whether or not the Settlement should be approved, plaintiffs, the members of the Class, and their officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, successors and assigns, either directly, representatively, derivatively, or in any other capacity, shall not commence or prosecute any action asserting claims against any of the Phillips Defendants or their present or former officers, directors, agents, attorneys, representatives, heirs, affiliates, subsidiaries, partners, successors or assigns which have been or could have been asserted in connection with, arising from or relating to, any of the matters or transactions referred to in the *Edelman* or *Lowenschuss* Chancery Actions or in the Consolidated Federal Actions or in the Stipulation. Each of the Courts have also reserved the right to

finally approve the Settlement without modification or with such modification as may be agreeable to the parties to the Settlement, without further notice to the stockholders of Phillips or the Class.

REQUESTS FOR EXCLUSION FROM THE CLASS

Any member of the Class shall be excluded from the Class if such person requests exclusion in writing in the manner hereinafter set forth and such request is received no later than ten (10) days prior to the first Settlement Hearing, *i.e.*, May 19, 1986. Persons who owned common stock of Phillips beneficially but not of record may request exclusion (i) through the corresponding record owner or (ii) directly, by supplying proof of ownership and the identity of the corresponding record owner with the request for exclusion. Any person duly requesting exclusion will not be bound by the Final Judgments entered in the Actions insofar as individual or class claims are concerned (although such person will be precluded by the Settlement from asserting the claim raised on the *Lowenschuss* partial summary judgment motion described above) except to the extent that such person may subsequently be certified as a class representative for a class consisting of members of the Class or any sub-class thereof. All members of the Class (whether or not such persons duly request exclusion from the Class) and all current stockholders of Phillips shall be bound by such Final Judgments and the provisions of the Stipulation in all other respects, including insofar as any derivative claims are concerned (which include without limitation all claims asserted in whole or in part against the Individual Phillips Defendants in the right of Phillips, with respect to the consent procedure bylaws and the Note Purchase Rights Plan adopted by the Phillips Board of Directors, and with respect to the substitution of the Preferred Share Purchase Rights Plan for the Note Purchase Rights Plan and the adoption of the Revised Consent Procedure Bylaw), as to which claims any such request for exclusion shall be of no force or effect. In addition, persons duly requesting exclusion from the Class will not be entitled to receive a distribution from the Agreed Payment to the Class should such amounts become payable in accordance with the provisions of the Settlement. All requests for exclusion shall be mailed to Phillips Litigation, P.O. Box 1036, Wilmington, Delaware 19899; shall state that the requesting person seeks exclusion with respect to the *Edelman* and *Lowenschuss* Chancery Actions and the *Hudson* and *Lawrence* Federal Actions; shall set forth the identity of the record owner of the shares as to which exclusion is sought and his address; shall set forth the identity of the beneficial owner of the shares as to which exclusion is sought and his address; shall state the number of shares of Phillips common stock, if any, owned on December 4, 1984 and the date and number of shares of Phillips common stock as to which exclusion is sought involved in any subsequent purchases, sales, tenders and/or exchanges of shares through and including March 29, 1985; and shall be signed by a person duly authorized to request exclusion, or they shall not be effective for any purpose. Any request for exclusion which states that exclusion is sought in any of the *Edelman* Chancery Action, the *Lowenschuss* Chancery Action, the *Hudson* Federal Actions or the *Lawrence* Federal Action, but not all said actions, or that exclusion is sought solely as to derivative claims, shall in either case be ineffective for any purpose. Members of the Class may not seek exclusion for less than all of their shares; provided, however, that record owners of shares which were beneficially owned by other persons may request exclusion for all shares which were beneficially owned by each such other person. The beneficial or record owner of any shares as to which a request for exclusion is properly submitted may not object to the Settlement or otherwise participate at the Settlement Hearings with respect to settlement of the individual or class claims, but may object or participate, if appropriate, with respect to the settlement of the derivative claims.

SCOPE OF THIS NOTICE

The foregoing description of the Actions, the Settlement Hearings, the terms of the Settlement and other matters described herein does not purport to be comprehensive. Stockholders of Phillips

and members of the Class are referred to the text of the Stipulation and the Orders relating to the Settlement referred to herein and to the pleadings and other papers filed and to be filed with the Courts in the Actions, which may be examined during regular business hours at the Office of the Register in Chancery in the Public Building, 11th and King Streets, Wilmington, Delaware 19801, and at the Office of the Clerk of the Federal Court, J. Caleb Boggs Building, 844 King Street, Wilmington, Delaware 19801. Any questions concerning this Settlement may be directed to William Prickett, Esquire, Prickett, Jones, Elliott, Kristol & Schnee, 1310 King Street, Wilmington, Delaware 19899 (with respect to the Settlement in the Chancery Court), or Joseph A. Rosenthal, Esquire, Morris & Rosenthal, P.A., One Customs House Square, P.O. Box 1070, Wilmington, Delaware 19899 (with respect to the Settlement in the Federal Court).

This notice is given with the approval and at the direction of the Chancery Court and the Federal Court.

HONORABLE JOSEPH T. WALSH

*Vice Chancellor (sitting by designation of the
Delaware Supreme Court) Court of Chancery of the
State of Delaware in and for New Castle County*

HONORABLE MURRAY M. SCHWARTZ

*Chief Judge United States District
Court for the District of Delaware*

Dated: March 19, 1986

APPENDIX I

SECTION 9. *Consents To Corporate Action:*

(a) *Action by Written Consent.* Any action which is required to be or may be taken at any annual or special meeting of stockholders of the Company may be taken without a meeting, without prior notice and without a vote, if consents in writing, setting forth the action so taken, shall have been signed by the holders of outstanding stock having not less than the minimum number of votes that would be necessary to authorize or to take such action at a meeting at which all shares entitled to vote thereon were present and voted; *provided, however*, that prompt notice of the taking of the corporate action without a meeting and by less than unanimous written consent shall be given to those stockholders who have not consented in writing.

(b) *Determination of Record Date of Action by Written Consent.* In order to inform the Company's stockholders and the investing public in advance that a record date for action by consent will occur and to comply with the procedures contained in the New York Stock Exchange policies and rules, the record date for determining stockholders entitled to express consent to corporate action in writing without a meeting is fixed by the Board of Directors of the Company pursuant to Section 213(a) of the Delaware General Corporation Law as follows: The Board of Directors shall set as the record date the 10th day after (i) any stockholder of record seeking to have the stockholders authorize or take corporate action by written consent without a meeting shall, by written notice to the Secretary which may be given by telex or telecopy, advise the Company of the corporate action proposed for which consents will be sought and request from the Board of Directors a record date unless a later record date is specified by such stockholder, or (ii) the Board of Directors determines that the Company should seek corporate action by written consent, unless a later record date is specified in the resolution of the Board of Directors containing such determination. In the event that the record date set as provided falls on a Saturday, Sunday or legal holiday, the record date shall be the first day next following such date that is not a Saturday, Sunday or legal holiday. Any record date determined pursuant to this subparagraph (b) shall be announced by press release prior to the opening of trading on the New York Stock Exchange on the next trading day after a request for a record date pursuant to subparagraph (i) above is received by the Secretary or a Board of Directors' determination pursuant to subparagraph (ii) above.

(c) *Duration and Revocation of Consents.* In order that the Company's stockholders shall have an opportunity to receive and consider the information germane to an informed judgment as to whether to give a written consent and in accordance with the procedures contained in the New York Stock Exchange policies and rules, the stockholders of the Company shall be given at least twenty (20) days from the record date to give or revoke written consents. Consents to corporate action shall be valid for a maximum of 60 days after the record date. Consents may be revoked by written notice (i) to the Company, (ii) to the stockholder or stockholders soliciting consents or soliciting revocations in opposition to action by consent proposed by the Company (the "Soliciting Stockholders"), or (iii) to a proxy solicitor or other agent designated by the Company or the Soliciting Stockholder(s).

(d) *Retention and Duties of Inspectors of Election.* Within two (2) business days after receipt of a request by a stockholder for the setting of a record date or a determination by the Board of Directors that the Company should seek corporate action by written consent, as the case may be, the Secretary of the Company shall engage nationally recognized independent inspectors of elections for the purpose of performing a ministerial review of the validity of the consents and revocations. The inspectors shall review all consents and revocations, determine whether the requisite number of valid and unrevoked consents has been obtained to authorize or take the action specified in the consents, and forthwith certify such determination for entry in the records of the Company kept for the purpose of recording the proceedings of meetings of stockholders. The cost of retaining inspectors of election shall be borne by the party proposing the action by consent.

(e) *Procedures for Counting and Challenging Consents.* Consents and revocations shall be delivered to the inspectors upon receipt by the Company, the Soliciting Stockholders or their proxy solicitors or other designated agents. As soon as consents and revocations are received, the inspectors shall review the consents and revocations and shall maintain a count of the number of valid and unrevoked consents. The inspectors shall keep such count confidential and shall not reveal the count to the Company, the Soliciting Stockholders or their representatives. As soon as practicable after the earlier of (i) 60 days after the record date for the consents or (ii) a request therefor by the Company or the Soliciting Stockholders (whichever is soliciting consents) made after expiration of the period for giving or revoking consents under subparagraph (c), notice of which request shall be given to the party opposing the solicitation of consents, which request shall state that the Company or Soliciting Stockholders (as the case may be) in good faith believe that it or they have received the requisite number of valid and unrevoked consents to authorize or take the action specified in the consents, the inspectors shall issue a preliminary report to the Company and the Soliciting Stockholders stating:

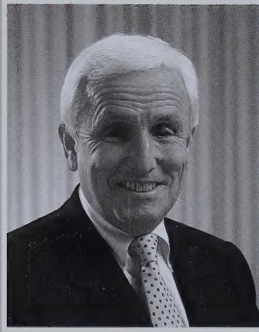
- (i) The number of valid consents;
- (ii) The number of valid revocations;
- (iii) The number of valid and unrevoked consents;
- (iv) The number of invalid consents;
- (v) The number of invalid revocations;
- (vi) Whether, based on their preliminary count, the requisite number of valid and unrevoked consents has been obtained to authorize or take the action specified in the consents.

Unless the Company and the Soliciting Stockholders shall agree to a shorter or longer period, the Company and the Soliciting Stockholders shall have 48 hours to review the consents and revocations and to advise the inspectors and the opposing party in writing as to whether they intend to challenge the preliminary report of the inspectors. If no written notice of an intention to challenge the preliminary report is received within 48 hours after the inspectors' issuance of the preliminary report, the inspectors shall issue to the Company and the Soliciting Stockholders their final report containing the information from the inspectors' determination with respect to whether the requisite number of valid and unrevoked consents was obtained to authorize and take the action specified in the consents. If the Company or the Soliciting Stockholders issue written notice of an intention to challenge the inspectors' preliminary report within 48 hours after the issuance of that report, a challenge session shall be scheduled by the inspectors as promptly as practicable. A transcript of the challenge session shall be recorded by a certified court reporter. Following completion of the challenge session, the inspectors shall as promptly as practicable issue their final report to the Company and the Soliciting Stockholders containing the information included in the preliminary report, plus all changes in the vote totals as a result of the challenges and a certification of whether the requisite number of valid and unrevoked consents was obtained to authorize or take the action specified in the consents.

(f) *Notice of Results.* The Company shall give prompt notice to the stockholders of the results of any consent solicitation or the taking of the corporate action without a meeting and by less than unanimous written consent.

(g) *Amendment, Repeal, Alteration or Modification.* Until five (5) years after the effective date of this bylaw, this bylaw shall not be amended, repealed, altered or modified except by a vote or consent of stockholders representing a majority of the issued and outstanding shares entitled to vote thereon; *provided, however,* that this bylaw may be amended, repealed, altered or modified by the Board of Directors of the Company when and to the extent that, in the written opinion of Delaware counsel, a statutory amendment or judicial decision represents a material change in Delaware law relative to the subject matter thereof and the amendment, repeal, alteration or modification conforms with such change of law.

Board of Directors



George B. Beitzel



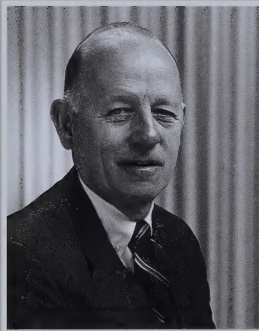
Michael N. Chetkovich



Glenn A. Cox



James B. Edwards



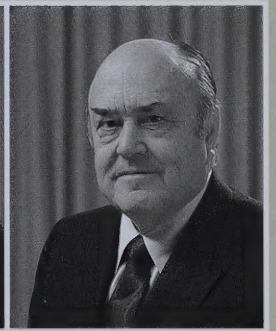
Robert F. Froehlke



E. Douglas Kenna



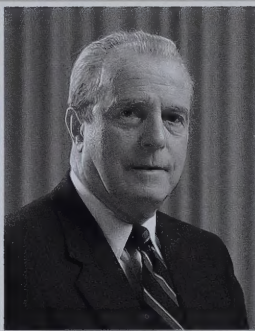
C.M. Kittrell



Melvin R. Laird



Carol C. Laise



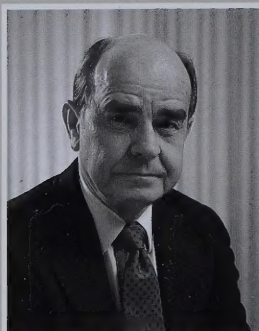
David B. Meeker



C.J. Silas



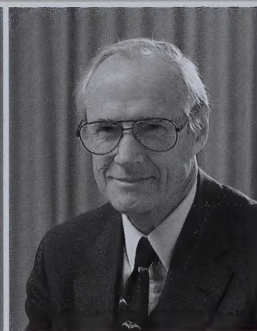
R.G. Wallace



W. Clarke Wescoe



Dolores D. Wharton



Francis M. Wheat



PHILLIPS PETROLEUM COMPANY
BARTLESVILLE, OKLAHOMA 74004